

STATE IMPEDIMENTS TO E-COMMERCE: CONSUMER PROTECTION OR VEILED PROTECTIONISM?

HEARING
BEFORE THE
SUBCOMMITTEE ON
COMMERCE, TRADE, AND CONSUMER PROTECTION
OF THE
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COMMERCE
HOUSE OF REPRESENTATIVES
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STATE IMPEDIMENTS TO E-COMMERCE: CONSUMER PROTECTION OR VEILED PROTECTIONISM?

THURSDAY, SEPTEMBER 26, 2002

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON COMMERCE, TRADE,
AND CONSUMER PROTECTION,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2322, Rayburn House Office Building, Hon. Cliff Stearns (chairman) presiding.

Members present: Representatives Stearns, Radanovich, Bass, and Towns.

Staff present: Ramsen Betfarhad, majority counsel, Yong Choe, legislative clerk; and Jonathan J. Cordone, minority counsel.

Mr. STEARNS. Good morning. The Subcommittee on Commerce, Trade, and Consumer Protection will come to order.

Welcome all of you, especially our witnesses to our hearing examining State impediments to e-commerce. This hearing is one of a number of hearings that the subcommittee has held on e-commerce this Congress. The other hearings have included examination of cyber security, cyber fraud and crime, impediments to digital trade, electronic communications networks, supplier-owned on-line travel sites and on-line information privacy.

I think it is important that the subcommittee and the full committee, as congressional custodians of the commerce clause be vigilant of and encourage interstate commerce in general and nascent forms of interstate commerce such as e-commerce, in particular.

As times change, economic and political priorities change. Now and again, history is witness to new and innovative technologies that demand and bring about fundamental change in the way commerce takes places. Those fundamental economic changes then, in turn, require and indeed bring about needed legal and regulatory change. The internet and the commerce that transpires on the internet are such technologies and innovations respectively.

Today, the value of on-line commercial activity at the business to business level is in excess of \$1 trillion worldwide. While consumer transitions taking place online are maintaining double digit growth rates year after year, it is essential that the growth of e-commerce is not stymied by laws and/or regulations that were enacted or promulgated at a time when e-commerce was at best a figment of a few technologists' imagination.

Many of those State laws and regulations did and may still have important consumer protection objectives as part of their rationale. I think it is imperative that every State carefully examine its laws and regulations that were intended to advance consumer protection, but now hinder e-commerce, albeit unintentionally.

I am confident that States will find alternative legal and regulatory approaches that will not impede e-commerce and at the same time advance State consumer protection interests. We will hear this morning that that is exactly what Illinois did when it examined and ultimately revised its auction licensing rule so that the rule could be more responsive to a new business model, not really an auction house, called eBay. However, there seems to be a trend where new State laws are enacted and old ones are reinterpreted with the distinct objective of protecting parochial, local commercial interests from out of State on-line competitors. It is neither new nor unusual for local commercial interests to appeal to their local governmental authorities for relief from new competitors made possible by technology or innovation.

Some of the greatest efficiencies accruing to the economy and the individual consumer from the internet and e-commerce has been in a dramatic reduction in the need for and cost of distribution.

As such, many traditional industries in the business of being intermediaries or middlemen are faced with significant competition from on-line providers of such types of services. So the hearing today focuses on three such industries, contact lens, the wine and auction house industries. The current intermediaries in the first two industries, optometrists and wine distributors/retailers face potentially significant direct competition from on-line providers of the same distribution services. Auctioneers face a serious competitive challenge in eBay, not an auction house in the traditional sense, but a cybermall of sorts that allows sellers and buyers from around the world to come together and trade over 10 million listings for goods and services on a given day.

In the context of their respective industries, today's witnesses will highlight some of the anti-competitive effects on their on-line businesses from State laws and regulations, some with clear protectionist intent, while most serve as a barrier to e-commerce because they are relics of a bygone era.

There are many other industries where State laws and regulations either unintentionally or intentionally are impeding the growth of e-commerce. Some of those other industries are subject of a forthcoming workshop at the FTC. The Commission has scheduled a 3-day workshop on the issue before us this morning starting October 8. The Commission hopes, among other things, to better understand particular State laws and regulations that impede e-commerce by having panels of experts address certain specific industries, including retailing, automobiles, cyber charter schools, real estate, mortgages, health care, pharmaceuticals, telemedicine, wine sales, auctions, contact lenses and funerals.

Upon completion of the Commission inquiry including its review of all of the pertinent filings made with the Commission, the subcommittee hopes to have the FTC testify as to their findings in a subsequent hearing in the 108th Congress.

So I look forward to our witnesses' testimony this morning and with that, I welcome the distinguished ranking member, Mr. Towns from New York.

[The prepared statement of Hon. Clifford Stearns follows:]

PREPARED STATEMENT OF HON. CLIFFORD STEARNS, CHAIRMAN, SUBCOMMITTEE ON
COMMERCE, TRADE, AND CONSUMER PROTECTION

Good morning. I am pleased to welcome you all, especially our witnesses, to the Commerce, Trade and Consumer Protection subcommittee hearing examining State impediments to e-commerce. This hearing is one of a number of hearings that the subcommittee has held on e-commerce this Congress. The others hearings have included examinations of (1) cyber-security (2) cyber-fraud and crime (3) impediments to digital trade (4) electronic communications networks (5) supplier-owned online travel sites; and (6) online information privacy. I think it important that the subcommittee and the full committee, as Congressional custodians of the commerce clause, be vigilant of and encourage interstate commerce in general and nascent forms of interstate commerce, such as e-commerce in particular.

As times change, economic and political priorities change. Now and again, history is witness to new and innovative technologies that demand and bring about fundamental change in the way commerce takes place. Those fundamental economic changes then in turn require and indeed bring about needed legal and regulatory change. The Internet and the commerce that transpires on the Internet are such technologies and innovations respectively. Today, the value of online commercial activity at the business-to-business level is in excess of one trillion dollars worldwide. While, consumer transactions taking place online are maintaining double-digit growth rates year after year.

It is essential that the growth of e-commerce is not stymied by laws and/or regulations that were enacted or promulgated at a time when e-commerce was at best a figment of a few technologist's imagination. Many of those state laws and regulations did and may still have important consumer protection objectives as part of their rationale. I think it imperative that every state carefully examines its laws and regulations that were intended to advance consumer protections but now hinder e-commerce, albeit unintentionally. I am confident that states would find alternative legal and regulatory approaches that would not impede e-commerce and at the same advance state consumer protection interests. We will hear this morning that that is exactly what Illinois did when it examined and ultimately revised its auction licensing rule, so that the rule could be more responsive to a new business model, not really an auction house, called e-Bay. However, there seems to be a trend where new state laws are enacted and old ones are reinterpreted with the distinct objective of protecting parochial local commercial interests from out-of-state online competitors. It is neither new nor unusual for local commercial interests to appeal to their local governmental authorities for relief from new competitors made possible by technology or innovation.

Some of the greatest efficiencies accruing to the economy and the individual consumer from the Internet and e-commerce has been in a dramatic reduction in the need for and cost of distribution. As such, many traditional industries in the business of being intermediaries or middleman are faced with significant competition from online providers of such distribution services. The hearing today focuses on three industries: (1) contact lens (2) wine and (3) auction houses. The current intermediaries in the first two industries, optometrists and wine distributors/retailers, face potentially significant direct competition from online providers of the same distribution services. While, auctioneers face a serious competitive challenge in e-Bay, not an auction house in the traditional sense, but a "cybermall" of sorts that allows sellers and buyers, from around the world, come together and trade over 10 million listings for goods and services on a given day. In the context of their respective industries, today's witnesses will highlight some of the anticompetitive effects on their online businesses from state laws and regulations, some with clear protectionist intent, while most serve as a barrier to e-commerce, because they are relics of a by-gone era.

There are many other industries where state law and regulation, either unintentionally or intentionally, is impeding the growth of e-commerce. Some of those other industries are subject of a forthcoming workshop at the FTC. The Commission has scheduled a three-day workshop on the issue before us this morning starting October 8th. The Commission hopes, among other things, to better understand the particular state laws and regulations that impede e-commerce by having panels of experts addressing certain specific industries, including: retailing, automobiles, cyber-

charter schools, real estate/mortgages, health care/pharmaceuticals/telemedicine, wine sales, auctions, contact lenses, and funerals (caskets). Upon completion of the Commission inquiry, including its review of all the pertinent filings made with the Commission, the subcommittee hopes to have the FTC testify as to their findings in a subsequent hearing in the 108th Congress.

I look forward to hearing the witnesses testimony.

Mr. TOWNS. Thank you very much, Mr. Chairman. Holding this hearing, let me begin by welcoming all the witnesses that I'm delighted to see and we're glad to have you here and we're looking forward to your testimony.

I understand that this is a hearing on State impediments of e-commerce, Mr. Chairman. Why are there no witnesses from a State regulator or a State attorney general? Should a State, at least one of them, should be here to defend their regulatory practice, at least one State. And many of the laws or practices of the States are set up to protect consumers. And the question we need to ask of ourselves is will our constituents save a few dollars on goods or services, is it worth the roll back of what many times are the protections as consumers? I'm interested to hear what our guests have to say about that.

With many interests before us, I am sure many separate opinions will be put forth and let me say here are some of mine. I'm greatly intrigued by the fact that I can buy a putter to improve my golf game from someone anywhere in America through on-line auction services like eBay. As long as these services have a policy to protect buyers and sellers, why should they not be allowed to do business? At the same time I question whether someone should be able to simply order contact lenses over the internet and get them shipped to their house without a doctor's verification. I have problems with that. What if the prescription is bad? What if it hurts the eyes? What recourse does that person have? Sometimes having the doctor nearby is in the consumer's best interest, even if it costs a few dollars more.

There seems to be a great rush to forget traditional brick and mortar businesses in favor of e-commerce. I am all for e-commerce. I want to make that point very clear in every way, but let's not forget, Mr. Chairman, that in some parts of this country, there exists areas where e-commerce is but an urban legend or an old wife's tale. The digital divide is real and we need to keep some options open for those who do not yet have the opportunity to participate in e-commerce.

I would like to thank you again for holding this hearing and to say to you that I think we need to hear from the States as well, but on that note, I yield back and I'm anxious and eager to hear from the witnesses.

Mr. STEARNS. I thank my colleague and I would tell him that our staff tried assiduously to get representation from the States and in fact, Mr. Dingell who is the ranking member of the full committee, his staff was trying to get members from the National Association of State Legislators to come. They were contacted. It was made clear to them what the itinerary and subject matter was here and they declined.

We contacted the States attorney generals to see if they had an interest in coming. Now we're not clear why they didn't want to participate. We appreciate your attempt here to make sure the

hearings are balanced and we get both sides and we, as you know, always try to do that and try to particularly try to give the Democrats every opportunity to get witnesses that they feel, so I'm just relaying to you what has been our efforts. Perhaps the efforts, instead of just 100 percent, should have been 200 percent, but any way, we did try and I regret, as you do, that we do not have an attorney general or perhaps some State legislators who would help us.

For an opening statement, the gentleman from California, Mr. Radanovich.

Mr. RADANOVICH. Good morning and thank you, Mr. Chairman, for having this hearing. Just a brief statement and I appreciate the Chairman's effort to get this issue on the table and I appreciate the fact that Mr. David Sloane of the American Business Association is invited to participate in this. It's no secret I have a small winery in California and I kind of find it difficult you can ship loaded weapons in between States, but you try to ship a bottle of Cabernet from California to Florida, you can go to jail and it's all part of the e-commerce and with this new technology that's coming forward, these are things, I think issues that need to be ironed out over time and I appreciate the fact that you're having this hearing and getting the issues on the table. So I just want to say thank you and I look forward to the testimony.

Mr. STEARNS. I thank my colleague. It's always nice to have someone, one of the members, who have actually—not only understand the problems, but have experienced it, so I think that's very helpful to have the gentleman from California.

[Additional statements submitted for the record follows:]

PREPARED STATEMENT OF HON. CHARLES F. BASS, A REPRESENTATIVE IN CONGRESS
FROM THE STATE OF NEW HAMPSHIRE

Thank you, Mr. Chairman, for holding this hearing. I am fascinated by this topic and the notion of state protectionism.

There are several competing forces at work for me when thinking about this issue. First, are Internet based transactions inherently Interstate? Because of the network's connectivity and the packet switching protocols employed, we never know if an e-mail, a transferred file, or the bits making up an order on any E-Commerce site traveled across state lines.

Because the data making up these transactions are broken up and transmitted through the network in a way that seeks out paths of least resistance and are then reconstituted at the other end, should a data bit that crosses a state line be thought of the same way as a good or service transacted through the mail across such borders? What if we are not sure of the vendor's or customer's actual location? Should we assume it Interstate? Why not International?

If a physical product is delivered through the mail, it is easy enough to track, but what about electronically delivered products, such as music or software downloads? This of course has implications beyond product regulation, it also affects how we tax, account for economic activity, and think about matching needs for physical infrastructure with citizen and local tax bases.

Second, what level of state oversight of the products and services sold over the Internet is appropriate given the international scope of the medium? Is there a compelling state interest in the types of regulations we are talking about? Or is the only purpose to protect an in-state product or enterprise? If the former is true, then we ought to tread more lightly. If it is the latter reason, then maybe we should no more tolerate that practice from the states then we do from foreign nations.

New Hampshire is a low barrier state. We have no sales tax—which may be the ultimate coercive regulation, and we generally avoid infringing on the freedom for willing buys and willing sellers to interact directly.

As I said, these are fascinating issues and I look forward to hearing from these panelists.

PREPARED STATEMENT OF HON. W.J. "BILLY" TAUZIN, CHAIRMAN, COMMITTEE ON
ENERGY AND COMMERCE

Thank you, Mr. Chairman. I appreciate your calling this hearing, which involves a critical function of this Committee in the emerging digital age: which is to make sure that actions that affect electronic commerce, sometimes in the name of consumer protection, are not, in fact, anti-consumer actions to stifle such commerce by non-digital competitors.

The timing of this hearing is important, as we see continued growth in the popularity of e-commerce and its importance in the American economy. Last month, the U.S. Census Bureau reported that second-quarter online retail numbers showed a healthy 24% increase from the previous year—and these data do not include sales from online travel, finance, and ticketing sectors.

As e-commerce continues to develop and mature, we will continue to face new and difficult public policy challenges. We certainly must determine what kind of new consumer protections are needed for this digital economy. An example of this is the debate occurring in this Subcommittee over the issue of information privacy.

We also must recognize that some consumer protections enacted long ago are not applicable for this new medium. Many laws on the books were designed under different circumstances for vastly different purposes, and can now threaten the development of e-commerce, with minimal or no offsetting benefit to consumers.

We should not forget that e-commerce produces fascinating new opportunities that will completely alter the way some businesses operate. By improving communications, reducing costs and time to market, minimizing inventories, improving consumer information and knowledge—just to name a few—the use of the Internet to conduct business can have substantial benefits for businesses and consumers alike.

Of course, in the process, e-commerce will also displace some of the existing companies and firms that have played a valuable role in our economic fabric for many years. One way it can threaten old business set-ups is by cutting out the middle man—disintermediation, as some call it—by connecting consumers directly with the producers of goods and services, often across state lines.

Now, in many cases there may be legitimate roles for middlemen in commerce. We examined some of these issues at a Subcommittee hearing on online travel services held a couple of months ago. But e-commerce can legitimately put those roles to the test, forcing them to prove their worth. And this is not a bad thing when it improves competition for certain goods and services. It can even enhance the middleman's role in some instances.

The reaction of middlemen, faced with the e-commerce threat, can well be predicted: sit by and watch it happen, or fight. Our concern today involves one set of tools that businesses have to use against e-commerce—state laws and state legislatures. If current middlemen use their political connections, entrenched position in the market, and the guise of "consumer protection" to influence state governments and regulators to protect them, then that's a problem—particularly when it affects interstate commerce.

And so I am interested to learn how state governments are reacting to the development of e-commerce—both negatively and positively. States and State Attorneys General play a vital role protecting consumers. But states, just like the Federal government, can be influenced by entrenched incumbents seeking to protect their market position though new laws or reinterpreted laws instead of through new services.

States' reactions to a middleman's quest for intervention to protect their position can be a telling sign of whether e-commerce will develop as we all hope. I expect our witnesses this morning will give us a good picture as to the reaction of states and "disintermediated" middlemen.

Let me note that I understand there will be a detailed, three-day FTC workshop on this subject next month. Chairman Muris should be thanked for pushing forward with such a thoughtful examination. I am hopeful that this hearing will be a helpful starting point for that workshop and, in turn, that their work may assist us, should this Committee move to consider any remedies that may be necessary.

I thank the Chairman and look forward to the testimony of the witnesses.

Mr. STEARNS. We welcome our first and only panel of Rob Atkinson, Vice President of Progressive Policy Institute; Mr. Tod Cohen, Associate General Counsel of Global Policy of eBay, Inc.; Mr. David P. Sloane, President of the American Vintners Association; Mr. Joe Zeidner, General Counsel for 1-800 CONTACTS; and Mr. Ted Cruz, Director, office of Policy Plant, Federal Trade Commission. So I

want to thank you for coming and let's start from my left and we'll go to my right.

Mr. Atkinson, we welcome you.

STATEMENTS OF ROBERT ATKINSON, VICE PRESIDENT, PROGRESSIVE POLICY INSTITUTE; TOD COHEN, ASSOCIATE GENERAL COUNSEL, GLOBAL POLICY, eBAY, INC.; DAVID P. SLOAN, PRESIDENT, AMERICAN VINTNERS ASSOCIATION; JOE ZEIDNER, GENERAL COUNSEL, 1-800 CONTACTS; AND TED CRUZ, DIRECTOR, OFFICE OF POLICY PLANNING, FEDERAL TRADE COMMISSION

Mr. ATKINSON. Thank you, Mr. Chairman, and members of the subcommittee. For those of you who don't know, I'm Vice President of the Progressive Policy Institute which is a think tank here in Washington. It's affiliated with the Democratic Leadership Council. For the last 4 or 5 years, one of our major missions has been to promote the growth of e-commerce because we see it as central to boosting productivity growth in the U.S. economy which we believe is central to boosting wages for American workers. And I think one of the key areas that we've looked at is this whole issue, as you articulated, how the middle man is fighting e-commerce.

I think one thing I want to mention before we start is there's a myth out there that maybe e-commerce isn't as healthy as it might be because of the dot com crash. Reality is, according to the U.S. Census Bureau, just one portion of e-commerce, e-commerce retail sales are growing 10 times faster in the last year than normal or regular retail sales are.

Consumers are happy about this. They get lower prices, more convenience and more choice. There's one group though that's not happy and you've articulated that, a whole set of producers in the middle of that transaction between the ultimate consumer and the producer, these middle men are not happy. And rather than compete in the marketplace which is the normal way businesses respond to competition, many of these companies and their associations are going to States, to the courts, to Congress, to basically fight against this competition. You've mentioned many of them. Let me just mention two.

One is you can all buy a computer today at Dell or Gateway and you can go directly to the manufacturer on-line and buy a computer and save hundreds of dollars by doing that. But you cannot buy a car on line. And I would just refer to Mr. Towns' comments. I think this is one of the critical areas where helping lower income people get on line, one of the major reasons they're not on line now is because it costs money to be on line. And if we can create an e-commerce system where they can save large amounts of money, for example, buying a car on line, you can save \$2,000 or \$3,000 or \$4,000, if you could buy it directly from the manufacturer, we would see much more adoption of e-commerce by lower income individuals.

Well, why are these companies doing that? Clearly, they're doing it for one simple reason. They don't want to compete. They want to be protected by government from competition.

I want to address one issue which I think is the key policy issue here and that's are they really protecting the consumer or are they

protecting themselves? If you look very carefully at the claims for consumer protection which we've done in a report called "The Revenge of the Disintermediated," how the middle man is fighting e-commerce and hurting American consumers, it's pretty clear that the cases divide into two groups. There's one group of cases where the claims of consumer protection are essentially frivolous and have no validity. I would argue the contact lens case is one of those. State attorney generals basically argue that there is no harm for purchasing contacts on line if one has a prescription which is currently what we're trying, what we would like to see.

In other cases there may be consumer issues. Wine sales is a good example. There is a legitimate concern in wine sales of underage drinking. But rather than just block all internet wine sales, the States that have allowed it have put in place underage signage requirements. You cannot deliver a bottle of wine to somebody unless they sign and show ID that they're over 18 years of age or 21, whatever the drinking age is in that State.

So it's clear that there are ways to protect consumers and PPI is not a libertarian organization. We don't believe that we should get rid of consumer protection. We need strong consumer protection, but what we need to do is make sure that it isn't set up in a way that limits e-commerce and limits any type of commerce.

What can Congress do about this? I think there are really three things Congress can do. One is simply in your own deliberations and as cases come before Congress, resist the protectionist pleadings of these interest groups that come before you.

I think the classic case is Orbitz. Orbitz' competitors in the on-line travel age space, as well as the travel agents themselves have been trying to get Congress to put political pressure on the administration to shut down Orbitz, close it down or to prohibit it or restrict it. The second thing and I support the FTC's efforts. The FTC is within the last year making strong cases at the State level in terms of their advocacy efforts and I know Ted will probably talk more about that and I think that's very important so that consumer voice gets in these debates at the State level.

Finally, I think it's important to really seriously look at the issue of preemption of State laws or requiring States to develop their own uniform laws. I think preemption is critical in e-commerce. I know, Mr. Chairman, your privacy bill does that. When we're in a national economic system where we're crossing State borders, we simply can't have these conflicting laws. We could do that in a number of areas, for example, nonbank financial services now are regulated at the State level. Why not let them be regulated at the Federal level as well if companies want to compete in all 50 States. They're still regulated. There is still consumer protection, but they're not restricted at the State level.

Automobile dealers is another example. Contact lenses, another example. Let the FTC make a ruling on contact lenses that is the same as eye glasses, require a prescription release.

So again our goal here is to enhance or at least to maintain consumer protection, but to do it in a way that doesn't restrict legitimate e-commerce.

Thank you very much. I'd be happy to take any questions.
[The prepared statement of Robert Atkinson follows.]

PREPARED STATEMENT OF ROBERT ATKINSON, VICE PRESIDENT AND DIRECTOR,
TECHNOLOGY AND NEW ECONOMY PROJECT, PROGRESSIVE POLICY INSTITUTE

Mr. Chairman, members of the Subcommittee, I am Rob Atkinson, Vice President and Director of the Technology and New Economy Project of the Progressive Policy Institute. PPI is a think tank whose mission is to define and promote a new progressive politics for America in the 21st century. It is a pleasure to testify before you on the issue of how middlemen are erecting legal and regulatory barriers to e-commerce. For several years, PPI has been keenly interested in promoting public policies to foster e-commerce, since we see it as a major driver of economic growth. However, we see the growth of laws and regulations that protect incumbent bricks-and-mortar companies from e-commerce competitors as a major threat to the growth of e-commerce.

As Americans realize they can save money—often a lot of money—by buying everything from books and CDs to contact lenses and airline tickets over the Internet, e-commerce continues to grow.¹ Notwithstanding the recent dot-com shakeout, the U.S. Census Bureau reports that in the second quarter of 2002 e-commerce retail sales grew 10 times faster than all retail sales. Almost 60 percent of American households are online and that number continues to grow.

While e-commerce is a progressive force for economic growth, not everyone benefits from its lower prices, expanded consumer choice, and enhanced convenience. In particular, a host of brick-and-mortar retailers, distributors, brokers, and agents—all manner of intermediaries—are at risk from the tide of e-commerce. For example, 15 percent of airline tickets are now purchased online, reducing the market share of bricks-and-mortar travel agents. But rather than compete fairly in the marketplace, travel agents and a host of other middlemen are seeking to erect all manner of barriers—including government legal actions, laws, and regulations—particularly at the state level, to hobble their online competitors. These are not just about intra-industry fights for competitive advantage; rather, they go to the heart of consumer welfare as protectionists in many industries limit consumer choice and keep more efficient competitors from the market. In a free market economy, consumers, not vested interests colluding and using the political process to impede competition, should decide how commerce is structured.

WHY DOMESTIC FREE TRADE MATTERS

In the old economy, people purchased most goods and services through companies or professionals located in their state. Even if people wanted to buy from out-of-state providers, with the exception of a small mail order catalogue industry, most consumers couldn't. Today, the rise of e-commerce enables Americans to buy a wide array of goods and services from sellers located in different states, all without going through a local middleman.

Using the Internet to bypass these bricks-and-mortar middlemen can bring dramatic savings to consumers. Selling homes on the Internet can reduce agent commissions by half. Buying a car directly from the manufacturer is estimated to lead to savings of thousands of dollars. Selling corporate and municipal bonds directly over the Internet can eliminate most of the 2 percent to 5 percent commission charged by middlemen. Trading futures contracts through the Internet is at least 50 percent cheaper than through bricks-and-mortar exchanges like the Chicago Board of Trade. Drawing up a will or other simple contract online can be 75 percent to 80 percent cheaper than using a lawyer. In short, e-commerce holds the key to boosting productivity growth in a host of industries.

But e-commerce is important not just because it saves consumers money, but because it gives them more choices. Consumers are no longer dependent upon local businesses to stock the products or provide the services they want, they can use the Web to search the world and find what they need.

THE MIDDLEMEN FIGHT BACK

In PPI's report, *The Revenge of the Disintermediated: How the Middleman is Fighting E-Commerce and Hurting American Consumers*, I documented how incumbent companies in a wide range of industries—including wine and beer wholesalers, auto dealers, music stores, travel agents, pharmacies, mortgage brokers, real estate agents, auctioneers, the U.S. Postal Service, lawyers, radiologists, and even college professors—are fighting against robust e-commerce competitors.

While some of these battles are fought at the federal level, many are playing themselves out in the states because that is where many industries are regulated. In the old economy, where the buyer and seller met face-to-face in the same state, states were the logical nexus for applying these industry-specific consumer protec-

tion laws and regulations. However, many of these laws and regulations that may have not been a barrier when most commerce was intra-state now unintentionally hinder e-commerce. In other cases, middlemen have been able to convince state legislators and governors that in the face of new competition, new protections are needed. In all cases, the simple fact that national e-commerce businesses are subject to 50 different state laws can raise their costs of doing business significantly. Some illustrative cases at the state and federal level are:

- In Colorado, representatives of the bricks-and-mortar pharmacy industry successfully lobbied to have legislation introduced to make it illegal for pharmacy benefit manager programs to impose lower co-pays for drugs purchased from pharmacies but through mail order and web orders.
- In Maine, optometrists lobbied for a prohibition against releasing prescriptions to their patients, to prevent consumers from ordering contact lenses online.
- Texas, at the behest of car dealers and their trade groups, stopped Ford Motor Co. from marketing used cars on the web, despite potentially huge savings to consumers.
- Seventeen states require companies brokering a mortgage to hire residents of the state and maintain a physical office there.
- The National Customs Brokers and Forwarders of America have fought against a proposal by the federal government to create an International Trade Data System to electronically collect all information for the federal government processing of trade.
- On anti-trust grounds, the travel agents and their trade associations have lobbied Congress and the administration to shut down Orbitz, the online travel site.

States differ widely on the extent to which their laws and regulations hinder e-commerce. In PPI's report, *The Best States for E-Commerce*, we ranked the states on 11 factors, including eight directly related to middleman resistance. The least restrictive states were Oregon, Utah, Indiana, and Louisiana. The most restrictive were South Carolina, New Mexico, Alabama, and somewhat surprisingly, California. But no state had a perfect record; all had at least one law or regulation that imposed barriers to e-commerce and consumer choice.

These restrictions are costly. PPI estimates that American consumers annually pay a minimum of \$15 billion more for goods and services as a result of such e-commerce protectionism by middlemen.² Net Choice, a coalition of tech firms and associations that promotes consumer choice on the Internet, is drafting an analytical report on the costs to U.S. consumers of these barriers to be published in concurrence with the FTC workshop in October on this topic. I would anticipate that the reported costs will be even larger than PPI's preliminary, conservative estimates.

CONSUMER PROTECTION OR PRODUCER PROTECTIONISM?

To listen to middlemen one might believe that without these laws consumers would be subject to the worst kinds of abuses. Wine wholesalers and retailers say that laws prohibiting wine sales on the Internet are needed to protect state tax revenues and limit underage drinking. Travel agents claim that they "act as the public's representatives and help keep prices low," while providing the buying public with choice.³ Car dealers claim that cars are so complex that dealers are needed to protect the consumer.⁴ Optometrists argue that buying contact lenses online will lead to eye damage. Pharmacists claim that without them, people will be buying inferior-quality drugs.

The reality is that states can design regulatory regimes that protect consumers without squashing competition. States that allow direct purchases over the Internet require that wine or beer shipments use a carrier that requires proof of age upon delivery. States can require that patients present a valid prescription order to obtain a prescription from an online pharmacy, and can pass reciprocity laws giving consumers legal recourse to file suit against out of state doctors.

In many cases, the claims of consumer risk are just a smokescreen for protectionism. For example, as the suit by 33 state attorneys general against the American Optometrist Association states, "The industry has hidden behind claims of health concerns requiring that individuals get their contact lenses from certain professionals, but there is no scientific basis to that claim," since the lenses sold online are identical to those sold in the optometrist's office.⁵ Travel agents' argument that they provide consumers with more choice and unbiased fare selection than online services is simply not true. The fact that many consumer groups have opposed many of these protectionist practices, including the auto dealer franchise and contact lens restrictions, suggests that these laws and regulations are not designed to protect consumers, but rather to protect producers.

If industries' claims of protecting consumers are a smoke-screen, what is their real motivation? It's much simpler: They seek to limit competition. For example, praising a decision by the state of Texas to prohibit Internet car sales by anyone other than car dealers, one Texas car dealer was quoted, in a moment of unusual forthrightness, as saying, "...I hope they [Internet car dealers] never take over."⁶ The head of the Texas car dealers' association, in explaining his support of the restrictive franchise laws, stated that the association would always be about "the property rights of its members. Don't expect us to change that." We shouldn't expect these groups to change. But we also shouldn't expect policymakers or the judiciary to protect the narrow interests of a select few in business over the broader interests of American consumers.

The disintermediated rely on another argument to defend these laws; they claim that consumers don't really want to bypass the middleman and therefore there is no need to go to all the work to dismantle these protections. On the contrary, if they are right and consumers don't want to buy online (the experience suggests otherwise), then these companies have nothing to fear from a level playing field. The National Association of Automotive Dealers put forth perhaps the most creative defense. They claim that even if car manufacturers tried to sell cars directly to consumers online, "they would still face a myriad of legal challenges and would run a great risk of breaking the law."⁷ But buying online directly from the manufacturer is against the law precisely because car dealers have pushed so hard to make it so.

Finally, many tribunes of industries justifying protectionist regulatory regimes claim that while other industries may be protectionists, they are not. Robert J. Maguire, the chairman of the National Automobile Dealers of America states, "For one thing, the role of the middleman is not the same from industry to industry. This is especially true of new car dealerships; their presence in the local community has long been recognized as "in the public interest" by state governments and the courts." At the end of the day, the fact that each of these laws or regulations has its own unique justification and call on the public interest does not mean that it's still not protectionist.

WHAT CAN CONGRESS DO?

Some of these e-commerce battles, like that concerning Orbitz and online travel, are being waged at the national level. As a result, the first step Congress and the administration can take is to *resist protectionist pleadings and oppose actions designed to protect the status quo against e-commerce competition*. This requires thoroughly analyzing the claims made by incumbents regarding consumer harm or gain.

But the federal government can also play an important role in helping to dissolve these state-level barriers. As the federal agency charged with protecting consumer rights, the Federal Trade Commission is well situated to weigh in on these debates at the state level. For example, the FTC recently provided formal comments to the Connecticut Board of Examiners for Opticians on a case regarding a restrictive interpretation of state laws related to the sale of contact lenses. The FTC can also file amicus briefs in court, as they did recently in federal district court in the matter of *Powers v. Harris*, which dealt with Oklahoma legislation that prevents anyone other than state-licensed funeral directors, including online sellers, from selling caskets. As a result, **Congress should support the FTC's e-commerce advocacy efforts.**

While it's important to try to convince states to repeal or modify their restrictive laws and regulations, at the end of the day, persuasion is likely to go only so far. For many states, the political forces for protection are strong and organized (in-state companies) while the beneficiaries of reform are diffuse (unorganized consumers) or not even in the state (e-commerce competitors). As a result, Congress should seriously consider creating on an industry-by-industry basis uniform national standards that enable e-commerce competitors to sell more easily in all 50 states. At one time it made sense for states to regulate local industries since all the activity was between sellers and buyers in the same state. The rise of national e-commerce makes this legacy regulatory framework a barrier to economic growth. As a result, **Congress could require states to develop uniform model legislation that does not discriminate against e-commerce competitors.** The Gramm-Leach-Bliley Financial Services Modernization Act used this approach to give states four years to have a uniform licensing requirement or reciprocity for insurance, and if they don't act, the federal system of insurance regulation would be imposed. This model could be applied to other areas. For example, Congress should also consider the possibility of requiring states to develop reciprocal licensing arrangements so that doctors licensed in any state could practice in any other, including practicing telemedicine.

In some cases, **Congress may need to let e-commerce companies doing business in areas currently regulated by states to be governed by new federal statutes.** For example, most non-bank financial service providers are subject to state laws, and are not eligible for national licensing. Congress should consider developing a national standard based on best-in-class requirements that states currently impose. E-commerce financial service companies would still have to abide by effective consumer protection laws, but they would have only one law to follow and it would be a law designed to promote e-commerce. There are other areas where a national standard makes sense. For example, the FTC should do what it did in 1979 for eyeglasses: simply say that prescriptions for contact lenses must be given to consumers, who can then choose where they want the prescription filled.

Some will argue that such federal preemption violates states' rights. In our view, this is a misleading interpretation of the notion of states' rights. The framers of the Constitution respected the rights of states to govern internal activities, but made it clear that they could not restrict interstate commerce. James Madison wrote, "Such a use of the power by Cong (sic) accords with the intention and expectation of the States in transferring the power over trade from themselves to the Govt. (sic) of the U. S."⁸ Federalism for the New Economy is not a paean to unlimited state freedoms. Rather, it requires a new bargain between Washington and states: on the one hand giving states more flexibility and accountability in many areas, as the Leave No Child Behind Act did; and on the other, developing national e-commerce governing frameworks in areas such as digital signatures, privacy, SPAM, or e-commerce protectionism. In these cases, state preemption is required to create a vibrant cross-border e-commerce marketplace.

CONCLUSION

The economic history of the United States is rife with business, labor, and professional organizations attempting to use the powers of government to protect their economic interests. During periods of rapid technological change, such as the present one, that produce new sets of winners and losers, political opposition to economic change increases significantly. It is incumbent upon policymakers at all levels of government, and in all branches, to resist the pressure from the disintermediated and ensure that e-commerce competitors are allowed to compete on a level playing field and not burdened with unfair and discriminatory rules, regulations, and laws.

Thank you for the opportunity to appear before you.

Notes:

¹ It should come as no surprise that a large number of dot.com companies are in trouble. Much of the investment made in the last few years was focused on attempts to become a market leader, beating out all the other companies. There are compelling historical parallels. The 1930s saw the bankruptcy of scores of automobile companies, but it was the takeoff point for the explosive growth of the auto industry. There is no reason to suspect that the current situation in e-commerce is any different. Moreover, the winners in e-commerce may not be the pure play dot.coms, but instead might be the "clicks and mortar" companies that use the Net to sell directly to consumers. In this case, pure-play dot.coms might not grow significantly, but e-commerce would.

² Robert D. Atkinson, *Revenge of the Disintermediated*, Progressive Policy Institute, January 2001 at <http://www.ppionline.org>.

³ Elizabeth Wasserman, "Stuck in the Middle," *Industry Standard* (March 6, 2000). Wasserman quotes Paul Ruden.

⁴ David Hyatt, "Franchise Laws in the Age of the Internet," White Paper, National Automobile Dealers Association, McLean, VA, January, 2001.

⁵ State of California, et al against The American Optometric Association, et al, in United States District Court, Eastern District of New York, January 17, 1997.

⁶ Robert Elder and Jonathan Weil, "To Sell Cars in Texas, Online Firms Are Forced to Enter the Real World," *The Wall Street Journal*, January 26, 2000, *Texas Journal*, p. T1.

⁷ NADA, op. cit.

⁸ James Madison to Joseph C. Cabell, 18 Sept. 1828. http://press-pubs.uchicago.edu/founders/documents/a1_8_3_commerces18.html.

Mr. STEARNS. Mr. Cohen?

STATEMENT OF TED COHEN

Mr. COHEN. Mr. Chairman, Ranking Member Towns and members of the subcommittee, my name is Tod Cohen. I'm Associate General Counsel for Global Policy at eBay. Thank you for inviting eBay to comment on the problem of unnecessary and harmful State regulation of electronic commerce. We share the concern that much of this regulation does far less to protect the public than to protect

entrenched monopolies and oligopolies. These regulations do not protect consumers, but penalize them.

We applaud you, Mr. Chairman, for calling this hearing to shine a spotlight on this disturbing trend.

eBay is the world's first and largest on-line trading community. Founded in September 1995, eBay has become the most popular shopping site on the internet. eBay brings together more than 50 million buyers and sellers from around the world to buy and sell practically anything. Last year, eBay users transacted over \$10 billion in sales.

Today, there are more than 10 million items for sale on our site and more than 1.5 million new listings a day. Sellers on eBay, to remain competitive, must charge prices that are competitive with both on and off line retailers. Such price competition is great for consumers, but troubling to the entrenched businesses that have been able to set prices unfairly for years without any repercussion. E-commerce forces them to face an unpleasant prospect: competition.

In order to prevent or "manage" competition, these interests have used their allies in State and local government to apply existing laws and regulations to internet companies in a discriminatory manner. They justify these new, discriminatory barriers with spurious claims that e-commerce may harm consumers.

My testimony today focuses on a few of the barriers that States have created and are considering that could inhibit the growth of e-commerce. Mr. Chairman, the introduction of your bill earlier this year, H.R. 2421, the "Jurisdictional Certainty Over Digital Commerce Act" points the way to a solution to this problem. H.R. 2421 would ensure a level playing field for e-commerce companies, thereby improving consumer choice.

First, let me talk about State regulations that impact the goods that we sell on the site. They already demand time-consuming and cumbersome efforts by our sellers to achieve compliance. The scope of goods and services on eBay alone is truly staggering, from BMWs to bulldozers, from antique furniture to high tech computers. Every single one of these sales could potentially be subject to regulation by one of the 50 States or even a county or municipality, keeping up to date with these potential regulations and existing regulations is practically impossible. However, we do believe that it is essential to create a safe and legal marketplace.

What is a constant struggle for eBay is completely beyond the resources of most of our sellers and other smaller e-commerce companies. On eBay alone we have 69 categories of goods and services that are either prohibited, questionable or infringing. Prohibited items include tobacco, prescription drugs, lock picking devices and postage meters. Certain items that may be listed that are questionable include event tickets, autographs and antique slot machines. To educate our buyers and sellers, we provide hundreds and hundreds of pages of explanations of why each category is included and under what circumstances, if any, certain items can be sold. Many prohibited or questionable items are included only because of State laws. One area where State and local laws are extremely varied and confusing to consumers are event tickets. Other areas of incon-

sistent State regulations include travel packages, packaged seeds and antique slot machines.

Now let me quickly turn to State auction laws that some would like to apply to eBay and our sellers. Even though we allow bidding for certain items on our site, eBay is neither an auctionsite nor an auction house, nor are our sellers auctioneers. We do not take possession of the goods, nor do we make any representation about the goods. We are essentially a cyber mall that is an unlimited number of store fronts where things can be sold and space to rent and sell their goods. We employ hundreds of individuals around the world to reduce fraud on our site. Nonetheless, some State regulators and entrenched middle men with whom they collaborate want to interpret State auction laws or pass new ones to regulate eBay, our sellers and other on-line marketplaces.

The licensing regimes are outrageous. For example, in North Carolina, you are required to pass an examine to prove your auctioneering aptitude, but you cannot take the exam until you have completed a mandatory 80-hour course on auctioneering. The curriculum includes 16 hours or bid calling, voice control, proper breathing technique and the use and sequence of numbers. Supplemental courses include tobacco, heavy equipment and most important for internet sales, hygiene, personal appearance and body language, something our late night sellers really need to improve.

Even more significant impediments would result because of substantive auction law provisions.

We have been working with one State that has attempted to apply these laws to us, Illinois, and we were successful in working with their licensing group to pass a law this year that would restrict the regulations and switch from a licensing scheme to a registration scheme. Over all, several other State legislatures have also proposed bills that would have regulated eBay or our sellers. A patchwork of these inconsistent State laws regulating the internet will hinder competitive marketplaces such as eBay. To protect consumers and allow them to enjoy the maximum benefits, Congress needs to enact bills like H.R. 2421.

Thank you for this opportunity to discuss these issues with the committee today. I'm available to answer any questions you may have.

[The prepared statement of Tod Cohen follows.]

PREPARED STATEMENT OF TOD COHEN, ASSOCIATE GENERAL COUNSEL—GLOBAL POLICY, EBAY INC.

Mr. Chairman and members of the Subcommittee: My name is Tod Cohen, and I am Associate General Counsel for Global Policy at eBay Inc. Thank you for inviting eBay to comment on the problem of unnecessary and harmful state regulation of electronic commerce. We share the concern that much of this regulation does far less to protect the public than to protect entrenched monopolies and oligopolies. The net result of these regulations is not to protect consumers, but to penalize them. We applaud you, Mr. Chairman, for calling this hearing to shine a spotlight on this disturbing trend.

eBay is the world's first and largest online trading community. Founded in September 1995, eBay has become the most popular shopping site on the Internet when measured by total user minutes, according to Media Metrix. eBay brings together buyers and sellers from across the United States and around the world to facilitate the sale of goods and services by a diverse community of individuals and businesses. Last year, eBay users transacted over \$10 billion in sales.

The vision of Pierre Omidyar in creating eBay was to design the ultimate, efficient marketplace. Today, with over 50 million registered users worldwide and over 10 million listings, eBay is fulfilling that vision. Buyers and sellers purchase goods and services easily, quickly, and cheaply. Whether selling through a bidding process or fixed-price format, sellers on eBay must charge prices that are competitive not just with other eBay sellers, but also with other on and offline retailers. Similarly, retailers in the traditional “brick-and-mortar” world can no longer base their prices merely on what their local market dictates—they must now consider the price that consumers will pay on eBay and at other Internet sites.

Such price competition is great for consumers, but troubling to the entrenched monopolists and oligopolists that have been able to set prices unfairly for years without repercussion. E-commerce forces them to face an unpleasant prospect: competition. In order to prevent or “manage” competition, these “middlemen” have used their allies in state and local government to apply existing laws and regulations to Internet companies in a discriminatory manner and to enact laws and regulations that treat interstate e-commerce companies differently from offline intrastate companies. They justify these new, discriminatory barriers with spurious claims that e-commerce may harm consumers. Far too often, though, these claims simply seek to mask the fact that the middlemen are just trying to protect their “turf.”

My testimony today will focus on a few of the barriers that states have created that could inhibit the growth of e-commerce and the need for Congress to begin to examine in more detail the growing problem of unnecessary and harmful state regulation of e-commerce. Mr. Chairman, the introduction of your bill H.R. 2421, the “Jurisdictional Certainty Over Digital Commerce Act” points the way to a solution to this problem. By clearly prohibiting state regulation over commercial transactions of goods and services conducted over the Internet, H.R. 2421 would ensure a level playing field for e-commerce companies, thereby improving consumer choice.

I. THE ISSUE—STATE REGULATION OF INTERNET COMMERCE

A. *eBay’s Efforts*

Already, certain state regulations demand time-consuming and cumbersome efforts by eBay and other e-commerce businesses to achieve compliance. These state regulations have the effect of penalizing consumers by limiting their access to goods and services offered online and increasing the prices consumers must pay. Moreover, these “rules of the road” do not fulfill their stated goal of increasing consumer protection.

The scope of goods and services available for sale on the Internet is almost limitless. On eBay alone, sellers from around the world currently offer over 10 million items for sale—over a million new items a day. The range of items is staggering: from BMWs to bulldozers, from antique furniture to hi-tech computers, from the oldest 78s to the most recent DVDs. Currently, over 18,000 categories of goods and services are being bought and sold on eBay. Every single one of these sales could, potentially, be subject to regulation by one of the 50 states, or even by a county or municipality. Keeping up to date with all of those potential regulations is impossible; nevertheless, we do our best to determine which federal and state laws apply to potential listings on our site because we believe that it is essential that we create a safe and legal marketplace.

What is a constant struggle for eBay is completely beyond the resources of smaller e-commerce companies, many of which are eBay merchants. They cannot analyze and develop compliance strategies for the laws of the hundreds of jurisdictions where their customers reside. Compliance with myriad, often inconsistent state and local laws should not serve as a barrier to entry to participate in the electronic marketplace.

In order to assist our sellers with the sale of certain goods, we created a list of “Prohibited, Questionable and Infringing Items.” This list is found at <http://pages.ebay.com/help/community/png-items.html>. It includes 69 categories of goods and services that either (1) may not be listed on eBay (“prohibited items”), including things like credit cards, tobacco, prescription drugs, lock-picking devices and postage meters; (2) may be listed under certain conditions (“questionable items”), such as event tickets, antique slot machines and autographs; or (3) may be in violation of certain copyrights, trademarks or other rights (“infringing items”). Furthermore, in order to educate consumers, our site provides hundreds of pages of explanations of why each category is included and under what conditions, if any, certain items can be sold.

Many of the items that are prohibited or questionable have been categorized that way because of state laws. For example, one area where state and local laws are extremely varied, confusing to consumers, and almost impossible to monitor, is the

resale of tickets to entertainment events (including sporting events, concerts, and plays). In order to assist users and to promote lawful ticket sales, eBay has attempted to identify the states that regulate the re-sale of event tickets and to provide its users with that information. We have identified seventeen such states.

State and local ticket regulations range from prohibitions against the sale of tickets at any price above face value to prohibitions against sales at a price of \$5 or 25% (whichever is greater) above face value. When a seller in one of the regulated states attempts to sell an event ticket, an automated disclaimer is added to that seller's item description explaining the applicable state regulation to potential buyers. This process is a difficult and inefficient experience for both eBay and our users. eBay has to try to determine both the seller and buyer's respective states of residence based on their eBay registration and their billing information. Identifying the state of residence of those buyers can be impossible because we do not require buyers to verify their location (just as offline marketplaces do not require proof of residence from a person who enters their store).

This is just one example of the numerous goods that are either prohibited or extremely hard to sell on the Internet simply because of inconsistent State regulations. Others include travel packages, packaged seeds and antique slot machines. In each case, inconsistent state regulation is undermining the ability of eBay to provide the ultimate efficient marketplace that our buyers and sellers seek and deserve.

B. Auction Laws

Beyond the current plethora of state restrictions on the sale of specific goods, there is also the threat that states will try to regulate modes of commerce. For instance, while eBay is neither an auction site nor an auction house, the listings on its site are often referred to as "auctions" because of the bidding process for which eBay often offers an online venue. As a result, some state regulators, and the entrenched middlemen with whom they collaborate, want to interpret state auction laws as regulating eBay and other online marketplaces that involve bidding. Recognizing that in most cases these laws cannot be interpreted in that way, they are also pushing for new laws to hobble their new Internet competition. The passage of such laws will only harm consumers and protect inefficient business models. Furthermore, the harm to eBay, our army of entrepreneurs, and our millions of customers could be significant.

Generally, auction laws require an auctioneer or auction house to obtain a license to conduct auctions. Obtaining such a license in all of the states with auction laws would be cumbersome and very costly. eBay and other online marketplaces potentially could do this; but millions of individual and small business eBay sellers certainly could not. Such licensing regimes could require every online seller to obtain state licenses (even in distant states) before he or she can sell goods on eBay.

In addition, these licensing regimes can be remarkably burdensome. For example to obtain an auctioneer license in North Carolina you are required to pass an exam to prove your auctioneering "aptitude." But, you cannot take the exam until you have completed a mandatory 80-hour course on auctioneering.

The curriculum includes 16 hours of "bid calling, voice control, proper breathing techniques and use and sequence of numbers..." These arcane requirements make no sense for sellers trading goods and services over the Internet. Other core requirements include 8 hours of "Auction Law: Rules and Regulations," and a variety of supplemental courses in such subjects as "Tobacco," "Cattle & Livestock," "Heavy Equipment," "Farm Machinery," and most important for Internet sales, "Hygiene, Personal Appearance and Body Language."

Beyond licenses, more significant potential dangers arise because of substantive auction law provisions. The most onerous of those common provisions is the requirement that the auctioneer or auction house be responsible for the items being auctioned and thus liable for any misrepresentation of the items being auctioned. Such a requirement makes sense as applied to a classic auctioneer or auction house because they actually take possession of the goods that are being sold; they review the condition of the goods; they authenticate the origins of the goods; they make sure that the auctioned goods are what is being advertised. To comply, traditional auctioneers charge more than four to five times the price that eBay charges sellers. In addition, traditional auctioneers charge up to 10% of the final value to buyers. In all but the most limited circumstances, eBay costs buyers nothing.

Applying this type of requirement to eBay, on the other hand, does not make sense because eBay does not conduct auctions. It never takes possession of the goods that are sold on its site nor does it make any representations about those goods. eBay is essentially a "cybermall" that has an unlimited number of storefronts where individuals and businesses can "rent" space to sell their goods and services. As a cybermall, eBay cannot be responsible for the representations that are made about

the over one million new items that are listed each day and continue to remain a viable business. Requiring eBay to comply with state auction laws would simply destroy the benefits buyers and sellers derive from eBay. Moreover, the traditional purpose of state auction laws is to ensure that sellers receive the funds from the sale of their property; this is not a problem for eBay since sellers arrange for payment directly with buyers. Thus, perhaps most important of all, applying these laws would not protect buyers or sellers.

II. A POSSIBLE RESOLUTION—THE ILLINOIS COMPROMISE

In late 1999, after the Illinois legislature amended the Illinois Auction Licensing Act to apply to the Internet, relevant state regulators contacted eBay to discuss the applicability of Illinois' auction laws to eBay. Earlier this year, after extensive discussions, the Illinois Office of Banks and Real Estate ("OBRE") agreed to work with us to amend the Illinois law. Instead of trying to fit a new business model into an existing regulatory structure, OBRE worked with us to craft a separate category of company that was not regulated in the same way as traditional auctions. The new bill was passed on May 23, 2002, and the governor signed it into law on August 15, 2002. Instead of a strict licensing requirement, the new law creates a simple registration scheme to allow individuals to contact businesses like eBay if problems arise.

III. THE THREAT REMAINS

While eBay would prefer not to register in states in which it is not physically located, we understand and respect the legitimate need of states to protect their citizens from bad actors. As a result, we are not here complaining about a statute like the Illinois registration act, as it does not threaten our business, our sellers, or e-commerce. We are, however, concerned about states that attempt to apply auction laws to eBay and that generally want to use state legislation and regulation to benefit their local businesses to the detriment of interstate e-commerce.

In the past year alone, several state legislatures have proposed bills that arguably would have regulated eBay and eBay's sellers. For instance in Missouri, the legislature considered a bill that potentially could have regulated online sales. The proposed bill defined auctions so broadly that it could have potentially included sales by sellers on eBay. Likewise, California and New York both proposed revisions to their current laws that were broad enough that they could arguably have applied to eBay and eBay's sellers. While these bills were defeated, they serve as examples of state proposals that could have substantially impacted e-commerce. A patchwork of inconsistent state laws regulating the Internet will hinder competitive marketplaces such as eBay that result from this incredible medium.

We recognize that much of this state regulation is vulnerable to legal challenge under several federal constitutional doctrines, as well as for inconsistency with applicable federal statutes, but expensive and interminable litigation is not the solution. In order to protect America's consumers and allow them to enjoy the maximum benefits from the competition that e-commerce can unleash, Congress needs to enact bills like H.R. 2421 that will prohibit state regulation over commercial Internet transactions.

Thank you for this opportunity to discuss this issue with the Committee today. I am available to answer any questions you may have.

Mr. STEARNS. I thank the gentleman.

Mr. Sloane?

STATEMENT OF DAVID SLOANE

Mr. SLOANE. Good morning, Mr. Chairman. My name is David Sloane. I'm President of the American Vintners Association, a national trade association of over 650 wineries in 48 States. I want to commend you for holding this important hearing on State impediments to e-commerce and I want to commend the Federal Trade Commission for also doing this.

The number of wineries in the United States has exploded in the past 25 years, rising from approximately 800 in 1975 to 2700 today and wineries now exist in all 50 States. Because wineries bring much needed investment capital, stable employment and significant tourism to depressed rural economies, States have played an

important role in helping the industry to develop. Unfortunately, however, America's wineries are also poster children for State impediments to e-commerce. Laws, in this case, which do more to protect the economic interest of in-state wholesalers than to further legitimate policy purposes such as preventing underage access or collecting taxes.

Following the repeal of prohibition in 1933, most States adopted a mandatory three-tier system of distribution requiring producers to sell only through wholesalers who in turn sell to retailers. This system worked reasonably well until the 1980's when consumer demand for boutique wines began to gather momentum. Despite changing consumer tastes, wholesalers have generally been unwilling to take on and properly service smaller wineries with limited production capacity and demand, preferring to stick with established national brands that generate substantial sales volume.

The requirement to sell through wholesalers flies in the face of an obvious reality. There are more than 25,000 labels nationwide and wholesalers simply will not commit the resources to servicing small wineries. Even in a large and vigorous market like Illinois, only about 525 American wine brands are available, about 2 percent of the total produced in the United States. Small wineries are then effectively locked out of the commercial mainstream.

To remedy the problem, wineries have aggressively lobbied State legislatures to permit the interstate shipment of wine to consumers, an alternative market mechanism that has gained increasing currency with the advent of e-commerce. In all, some 23 States now have laws or regulations permitting consumers to buy limited quantities of wine from out of State wineries.

While wholesalers have been unwilling to represent small wineries, they have been more than willing to exercise their considerable political clout in State capitals across the country to oppose direct shipment and even to make it a crime. Under the guise of protecting citizens against the evils of alcohol, they have won enactment of felony statutes in five States, Florida, Georgia, Kentucky, Maryland and Tennessee, and misdemeanor statutes in another 18.

Preventing underage access and collecting taxes are the primary justifications for State bans of interstate wine sales. However, experience in the States that do permit such commerce reveals the transparency of these arguments. With the exception of wholesale or orchestrated stings, we are not aware of any prosecutions involving the sale of wine to minors via the internet. Of course, the same cannot be said of the three-tier system where millions of illegal alcohol sales to minors are consummated every year.

With respect to tax collection, States which allow the interstate shipment of wine to consumers report no appreciable decrease in excise tax collections from lost wine sales. In those States which make payment of excise taxes a condition of holding a direct shipping permit, wineries willingly make such payments. Given the cost of collecting State excise tax receipts on wine shipped from other States, however, some States forego such collections. The so-called reciprocal shipment States, those that allow consumers to buy from wineries in other States and vice versa, assume the revenue implications of direct shipping to be a wash.

To seek redress, wineries and consumers have now challenged the constitutionality of State laws, banning the interstate shipment of wine in seven States, arguing that such discrimination is impermissible under the Commerce Clause, notwithstanding the powers granted to States under the 21st Amendment.

Hopefully, this issue will soon be ripe for Supreme Court consideration. While we have not been successful in all of these cases, virtually every Federal judge that has examined this conflict has concluded that less extensive and intrusive mechanisms than the mandatory three-tier system could accomplish these State interests.

Congress has a clear constitutional role to play in developing ground rules for when and how States may interfere with interstate commerce and because the internet greatly enhances the potential for remote commerce, it is imperative that action be taken soon. State barriers to on-line wine sales and rigid adherence to the three-tier system are impeding the successful development of the American wine industry and the potential benefit of that economic activity for depressed rural economies.

By statute, the Congress should establish a test for balancing State interests with the basic and fundamental right to a national marketplace embodied in the Commerce Clause. In so doing, Congress can provide important guidance to the courts and to the States. In *Central Hudson Gas Electric versus Public Service Commission*, a 1980 Supreme Court case, the Supreme Court developed an excellent balancing test for a very similar purpose that the Congress should look to as it develops legislation to eliminate unnecessary barriers to all forms of e-commerce.

The Central Hudson test requires one, the demonstration of a substantial State interest; two, a showing that the regulation or law in question directly advances the governmental interests; and three, that the regulation or law is not more extensive than necessary to serve the stated purpose. Such a law would help to mitigate the special interest political power of local businesses and ensure that parochial State interests do not supersede the national interest of free and unfettered commerce among the States.

On behalf of America's small craft wineries, I urge this subcommittee to advance legislative to require States to meet such a standard so that these businesses can be freed to serve consumers without undue and unreasonable impediments.

Thank you.

[The prepared statement of David Sloane follows.]

PREPARED STATEMENT OF DAVID SLOANE, PRESIDENT, AMERICAN VINTNERS
ASSOCIATION

Good morning, my name is David Sloane. I am President of the American Vintners Association, a national trade association with over 650 wineries in 48 states. I want to thank and commend the Subcommittee for holding this hearing to examine state barriers to e-commerce, and whether such barriers serve rational policy purposes, or amount to economic protectionism.

The number of wineries in the United States has exploded in the past 25 years, rising from approximately 800 in 1975 to over 2,700 today. Indeed, as an article in *USA Today* recently observed, wineries are now a part of the rural farm economy in all 50 states. A large percentage of this growth has occurred in just the past twelve years. Since 1990, the industry has roughly doubled from 1,400 wineries to its current number.

While California remains the premier winegrowing state—comprising roughly half the nation’s wineries and over 90% of the production—there are high concentrations of wineries (in rank order) in Washington, Oregon, New York, Ohio, Virginia, Pennsylvania, Texas, Missouri, Colorado, New Mexico, Illinois and Michigan. These states have a minimum of 30 wineries each, and the top three—Washington, Oregon and New York—have more than 150 apiece.

States have played a major role in encouraging this remarkable growth because wineries bring much-needed investment capital, stable employment, and significant tourism to depressed rural economies. In fact, for every bottle of wine sold at a farm winery, there is an investment of approximately \$50 in land, development, equipment and working capital. Suffice it to say, farm wineries are a living embodiment of the American ideal of entrepreneurial craft spirit.

MANDATORY THREE-TIER DISTRIBUTION SYSTEM

Unfortunately, America’s wineries are also “poster children” for state impediments to e-commerce—laws in this case—which do more to protect the economic interests of in-state wholesalers than to further legitimate policy purposes, such as preventing underage access or collecting taxes.

Following the repeal of Prohibition in 1933, most states adopted a mandatory three-tier system of distribution, requiring producers to sell only through wholesalers, who in turn sell to retailers. This system worked reasonably well until the 1980s, when consumer demand for “boutique” wines began to gather momentum. Despite changing consumer tastes, wholesalers have generally been unwilling to take on, and properly service, smaller wineries with limited production capacity—preferring to stick with national brands that generate substantial sales volume.

This requirement to sell through wholesalers flies in the face of an obvious reality: Wholesalers do not sell, or properly service, the products of smaller wineries. There are too many labels nationwide—some 25,000 in total. Even in a large and vigorous market like Illinois, only about 525 American brands are available—about 2 percent of the brands produced by U.S. wineries. The three-tier system just does not work for small wineries.

As the number of brands and labels has proliferated, the challenge of securing wholesaler representation has become a crisis for small, and even medium-sized, wineries. This “market access” crisis is further exacerbated by the massive consolidation that has occurred within the wholesale tier. By some estimates, the number of wine and spirits wholesalers has declined from a high of 5,000 in the 1950s to less than 400 today.

THE DIRECT SHIPPING ALTERNATIVE

To remedy the problem, wineries have aggressively lobbied state legislatures to permit the interstate shipment of wine to consumers—an alternative market mechanism that has gained currency with the advent of e-commerce. The most functional form of direct shipment legislation has been the “reciprocal” shipment concept, which permits consumers to receive a small quantity of wine each month from wineries in other states affording the same reciprocal privilege to consumers within their own state.

Thirteen states have enacted reciprocal shipment laws. Another nine states have enacted “permit” laws, which, to varying degrees, also facilitate the interstate shipment of wine to consumers. However, it is worth noting that several of these laws—whether because of permitting fees, burdensome paperwork requirements, or unwieldy purchasing mechanisms—have not been utilized. Indeed, a few such laws were drafted by wholesaler interests to placate state legislatures that were being pressured by consumers to do something. Additionally, a few states, and the District of Columbia, have made regulatory allowances for small wine shipments.

ECONOMIC PROTECTIONISM

While wholesalers have been unwilling to represent small wineries, they have been more than willing to exercise their considerable economic and political clout in state capitals across the country to oppose direct shipment, and to make it a crime. Under the guise of “protecting citizens against the evils of alcohol,” they have won enactment of felony statutes in five states (Florida, Georgia, Kentucky, Maryland and Tennessee), and misdemeanor statutes in another 18 states.

Indeed, as a direct consequence of wholesaler lobby campaigns, more than half of the states—including several with large populations—have effectively shut all but the top 100 wineries out of their markets by insisting that all products go through the mandatory three-tier system.

These protectionist laws hurt wineries, to say nothing of consumers, in many ways. For example, they prevent wineries from selling and shipping wine to visiting tourists from states that prohibit interstate shipment; from including such consumers in their wine club offerings; and, from fulfilling gift orders to consumers from such states.

Preventing underage access and collecting taxes are the primary justifications for state prohibitions against interstate wine sales. However, experience in the 23 states that *do* permit interstate wine sales to consumers reveals the transparency of these arguments. In fact, with the exception of wholesaler-orchestrated stings, we are not aware of any prosecutions involving the sale of wine to minors via the Internet. Of course, the same cannot be said of the three-tier system, where millions of sales to minors are consummated every year.

With respect to tax collection, states which allow the interstate shipment of wine to consumers report no appreciable decrease in excise tax revenues from lost wine sales. In fact, a model law has been developed which protects both excise and sales taxes by licensing out-of-state shippers, and requiring them to collect and forward these taxes.

State statutes banning the direct shipment of wine protect the pecuniary interests of politically powerful in-state wholesalers, and raise an insurmountable barrier to the consummation of commerce between willing consumers and out-of-state sellers. This strange confluence is a product of raw local political power of precisely the sort that the Constitution seeks to discourage: “[Each State] would pursue a system of commercial policy peculiar to itself... States might endeavor to secure exclusive benefits to their own citizens.” (Federalist VII).

The contention that these protectionist laws serve some legitimate policy purpose is merely a ruse, designed to mask blatant local favoritism. Virtually every Federal judge that has examined this conflict has concluded that less extensive and intrusive mechanisms than the mandatory three-tier system could accomplish legitimate state interests.

There is a need for a safety valve, and that safety valve is to allow the limited direct shipment of wine to consumers. The Supreme Court has commented on the importance of a national marketplace for farmers and craftsmen: “Our system, fostered by the Commerce Clause, is that every farmer and every craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation... Likewise, every consumer may look to the free competition from every producing area in the Nation to protect him from exploitation by any. Such was the vision of the Founders; such has been the doctrine of this Court which has given it reality.” *H. P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525 (1949) [Cited favorably in 1994 West Lynn Creamery].

Members of the American Vintners Association are both farmers and craftsmen.

CONGRESS CAN AND SHOULD ACT

Congress has a clear constitutional role to play in developing ground rules and boundaries for when and how states may interfere with interstate commerce—and because the Internet greatly enhances the potential of remote commerce, it is imperative that Congress act soon. State barriers to online wine sales, and rigid adherence to the three-tier system are impeding the successful development of the American wine industry, and the significance of that economic activity for depressed rural economies. In addition, these laws are raising the ire of consumers, who fail to comprehend why they cannot order and take delivery of wine from their favorite winery.

By statute, the Congress can and should balance the public policy needs of the states with the basic and fundamental right to a national marketplace embodied in the Commerce Clause. In doing so, it can also provide important guidance to the courts.

In *Central Hudson Gas and Electric v. Public Service Commission*, 447 U.S. 557 (1980), the Supreme Court developed an excellent balancing test for a very similar purpose that the Congress should consider as it looks to develop legislation to eliminate unnecessary barriers to e-commerce. The Central Hudson test requires: 1) the demonstration of a substantial state interest; 2) a showing that the regulation or law in question directly advances the governmental interest; and, 3) that the regulation or law is not more extensive than necessary to serve the stated interest.

It can be argued that every commercial regulation serves some legitimate policy concern or another. To mitigate the special interest political power of local businesses and to ensure that the concept of a national marketplace is not subverted or unreasonably attenuated, Congress should provide clear statutory guidance. Parochial state interests should not be allowed to supercede the national interest of free and unfettered commerce among the states.

On behalf of America's small "craft" wineries, I urge this Subcommittee to advance legislation to require states to meet such a standard so that these businesses can be freed to serve consumers without undue and unreasonable impediments. Thank you.

Mr. STEARNS. I thank the gentleman.
Mr. Zeidner?

STATEMENT OF JOE ZEIDNER

Mr. ZEIDNER. Thank you. My name is Joe Zeidner. I'm General Counsel with 1-800 CONTACTS. I appreciate you allowing us to come here today.

What I'd like to do, if it's okay, is just talk to you a little bit about our business. I have prepared something in writing, but—

Mr. STEARNS. We'll be happy to put it as part of the record, your written statement. By unanimous consent, so ordered.

Mr. ZEIDNER. Contact lenses are perfect for e-commerce. They're small, light, easy to ship and they're exactly the same as the contact lenses you buy from your eye doctor. These lenses right here are the fastest growing portion of the industry. Daily lenses. You throw them away every day. This is a 3-month supply. Most popular right now is 2 week lenses. This is a 3-month supply right here. Monthly lenses comes in vials like this. This is a 3-month supply, if you wear them each month.

Although there have been tremendous advances in the technology of contact lenses, there's also been tremendous advances in the distribution method of contact lenses. It used to be you'd only buy them from your eye doctor. Now you can buy from the internet, from mass retailers, pretty much anywhere you'd like to. However, there is a myriad of State laws and regulations that's been erected that stifle competition and don't allow consumers the right to choose? Why do you ask or would you ask or do we ask? Why are there laws and impediments in place that wouldn't allow people to be able to buy where they want to? Because there's an anomaly in health care. Eye care providers sell the products that they prescribe. And when they play both retailer and prescriber, there comes a natural conflict of interest that spins off a myriad of State laws and regulations that are intended both to protect the health of the consumers, but also to protect these retailers from competition.

Originally, it was necessary to have eye care doctors sell what they prescribe. I don't know if you remember, but when contact lenses first came out they were hard lenses and they were made specifically for your eye. You might remember basketball games or movie theaters where they would stop everything and say stop, there's a contact lens on the floor. It's because it couldn't be replaced. It was custom made for your eye. That's no longer the case. These are made by the millions now. They're stamped out and they're the same every single time. There's 10,000 different parameter that people can wear, so they're perfect for centralized distribution.

The retailer around the corner, the eye doctor who does your eye exam can't possibly carry all the different contact lenses in stock, but we can, with one centralized distribution facility.

Today, there's no need to buy your contact lenses only from your eye doctor. You should be able to buy them from anywhere you want to, Cosco, Walmart, 1-800 CONTACTS or your eye doctor. However, there are State laws that have been put in place and regulations that have been put in place to stifle competition. They really fall into three main categories.

First off, prescription release. In about half the States, believe it or not, you have no right to your contact lens prescription. Although there's a Federal law that requires mandatory release of your eyeglass prescription, you have no right, federally, and in about half the States, to your contact lens prescription. Once again, this is a throw back to the days of contact lenses being custom fit to your eye. Therefore, there would be no reason to give you a prescription.

Second, and also as a spin off of that, in some States where you are allowed to have your prescription, you have to sign a waiver to get your own prescription or in other States you have to have an original hand-signed copy of your prescription, not a fax, not an e-mail, not a phone call, an original hand signed copy from your doctor before you can purchase from anyone else other than him. That's the first area where State laws impede competition in our industry.

Second, the prescription date is sometimes by State law unduly short, without medical reason, to force you come back to your eye doctor for another exam and hopefully for your eye doctor to purchase contact lenses from him.

I would like to submit for the record an article that was in a major optometry magazine that's called "If You Can't Beat Mail Order, Joint Them." And in this article, I'll just read one quote, Dr. Goldberg, who is an emeritus fellow of the American Academy of Optometry says "patients should obtain mail order lens replacement only during the service life of the lens prescription, therefore practitioners must limit the service life of a lens prescription."

I recommend a 6-month interval. Hard lenses were much more dangerous for your eye because you would wear them for many years at a time. These lenses you throw away every day, yet the profession is advocating that you come in every 6 months so that you come back in and buy your lenses from them. That's the second area of State law that we've seen that impedes competition.

And probably the most insidious area is requiring the brand name on the prescription and prescribing a boutique or private label brand. The latest—if you're able to get a copy of your prescription and buy where you want, if you get a prescription for a brand that is only sold by your doctor's office, you really don't have any choice. That's where we're seeing a lot of the growth in the industry, is in the private label section.

I'd also like to submit one other document for the record that was also in the Contact Lens Spectrum Magazine that's entitled "Using Private Label Lenses to Keep Patients in the Practice." And in this article, the optometrist says "we use private labeling a lot. I think that originally we were fitting lenses from Ciba, Bausch & Lomb and would get calls from patients and 1-800 CONTACTS asking us for their contact lens prescriptions. I wanted to use another strategy to prevent that from happening.

Now when patients want to order a lens, they like the particular lens that we provide. It's a private label. So they can't get it anywhere else. It makes it a lot easier for them to come back to us. If they go to Walmart or COSCO or some place like that and ask do you have this lens, COSCO or Walmart or 1-800 would say yes, we do, but it's a different name on the box. This creates the problem within the patient's mind about whether or not it's the same lines. I often don't give the patients a choice. I don't say this is a private label lens. I just say this is the best lens for you. It's the one you should be wearing."

We think that this industry is ripe for congressional investigation. We think that there are health concerns with contact lenses and we completely agree with that. We just think that those concerns are not dependent on where you buy your contact lenses, that people's health should be balanced with their right to choose where to buy contact lenses. Thank you.

[The prepared statement of Joe Zeidner follows.]

PREPARED STATEMENT OF JOE ZEIDNER, GENERAL COUNSEL, 1-800 CONTACTS,

Mr. Chairman and Members of the Subcommittee, my name is Joe Zeidner, General Counsel for 1-800 CONTACTS. Our company sells replacement contact lenses to consumers through an Internet web site and a toll-free telephone number. I appreciate the opportunity to appear before the Subcommittee today.

I commend you, Mr. Chairman, for holding this hearing to examine the impediments imposed by states on e-commerce. When it comes to contact lenses, this issue impacts the pocket books—and the ocular health—of a great many Americans. Today, thirty-five (35) million Americans wear contact lenses. While Americans of all ages wear contacts, our typical customer is female between the ages of twenty-five (25) and forty-four (44). Americans spend more than \$3.5 billion every year on contact lenses.

In many instances, state laws and regulations on contact lenses, while cloaked as health measures, work to: (1) stifle competition—the driving force for innovation, efficiency, and customer service; (2) increase prices consumers pay for contact lenses; and (3) actually compromise, rather than promote, the ocular health of contact lens wearers.

Before providing the Subcommittee with a more detailed analysis of these state laws and regulations, please allow me to note some things for the record.

First, 1-800 CONTACTS respects the important role that eye care professionals play in our health care system. We are not a substitute for personal eye care. Each day, a growing number of eye care providers work cooperatively with us. We are encouraged by our recent experience in California where consumer groups and the California Optometric Association worked to craft legislation (signed earlier this week by Governor Davis) that protects the health of contact lens wearers, while allowing for fair competition.

1-800 CONTACTS recognizes there are risks inherent in wearing contact lenses and strongly supports the retention of measures which legitimately protect consumer health.

However, these risks are not related to where a consumer purchases replacement lenses. An investigation conducted by state attorneys general examining the contact lens industry concluded that,

"[P]urchasers from alternative channels have had no greater ocular health problems than purchasers from ECPs [eye care professionals]. Our multi-state investigation has failed to reveal any study showing any correlation between compromised ocular health and receipt of lenses through alternative channels."

In addition, in settling anti-trust claims brought by 32 state attorneys general, the American Optometric Association specifically agreed that it shall not represent directly or indirectly that the incidence or likelihood of eye health problems arising from the use of replacement disposable contact lenses is affected by or causally related to the channel of trade from which the buyer obtains such lenses. Specifically, the AOA shall not represent directly or indirectly that increased eye health risk is inherent in the distribution of replacement disposable contact lenses by mail order or pharmacy or drug stores."

Perhaps the greatest threat to ocular health faced by contact lens wearers is caused by failing to dispose of contact lenses frequently enough. Doctors have reported that frequent replacement of lenses significantly reduces eye infections and inflammation among disposable contact lens wearers.

The less expensive contact lenses are and the easier they are to obtain, the more frequently wearers will change their lenses. According to a McKinsey and Company survey, fifty-seven (57) percent of consumers would replace their lenses more frequently if lenses were cheaper. Thirty (30) percent of consumers listed cost savings as a reason for over-wearing lenses. Moreover, twenty-two (22) percent of consumers stated they wear lenses longer than they should because “purchasing them is inconvenient.”

Finally, while too many states have protectionist laws shielding vested interests from competition, a few states have adopted laws that should help their residents benefit from e-commerce. Some of these states, for example, have laws expressly authorizing the online purchase of contact lenses.

Why would states want to impose barriers to e-commerce when it comes to sales of replacement contact lenses, especially when such barriers can threaten, rather than promote, consumer health? To answer this question, it helps to understand how the contact lens industry works.

A BRIEF HISTORY AND OVERVIEW OF THE CONTACT LENS MARKET

Originally contact lenses were custom made from rigid materials. Commonly called “hard” lenses, they required eye care professionals to engage in the labor-intensive practice of customizing the fit of lenses to each patient’s eyes. As hard contacts were a customized item, consumers were effectively limited to purchasing them only from eye care professionals.

Technological advances led to the introduction of “soft” contact lenses in the late 1980s. Unlike customized hard lenses, soft lenses are standardized, mass-produced commodities. The most popular soft contact lenses are disposable and are designed to be replaced every two weeks. The fastest growing segment of the industry are disposables that are replaced every day. Currently, soft lenses are worn by approximately 85 percent of all contact lens wearers. More than 90 percent of the orders we ship are for disposable soft lenses.

As the market moved towards mass-produced disposable lenses, consumers began to purchase their lenses from outlets other than the doctor who prescribed them. A variety of entities—pharmacies, mass merchandisers, and mail order companies—began selling replacement contact lenses directly to consumers.

Contact lenses are perfect for centralized distribution. Boxes of contact lenses are small, light, and easy to ship and the product must be replaced regularly. Because of the wide spectrum of possible parameters, the product is just too unwieldy for the average eye care professional to maintain stocks sufficient to quickly meet all of their customers’ needs.

Companies with the ability to (1) centralize distribution, (2) store hundreds of thousands of different prescription parameters; (3) purchase in bulk; and (4) execute Internet and phone orders, can bring efficiencies to the market place—efficiencies which benefit consumers through lower prices and more convenient service. Once a customer has ordered from us, getting replacement lenses should be as easy for the customer as a couple of clicks.

Unfortunately, the efficiencies of this business model (and the benefits it makes available to contact lens wearers) are in many states being thwarted by unnecessary regulations and statutes which shield vested interests from the competition and market efficiencies made possible by the advent of disposable soft lenses and the Internet.

The introduction of soft disposable lenses did more than change the economics of the contact lens business—it also created a conflict of interest: Eye doctors sell the products they prescribe.

There is no customization of disposable contacts. Consumers most often buy these mass-produced lenses four 6-packs at a time. Daily disposable customers commonly buy 180 or 360 lenses at a time.

When contact lenses were custom made, it was necessary for eye care professionals to sell the lenses they fit on their own patients. With disposable, mass-produced, widely available soft lenses, it is no longer necessary for the prescriber to sell what they prescribe.

As the market place transitioned to soft disposable lenses, the practices of eye care professionals remained the same. They retained the ability to both prescribe and sell contact lenses, creating a conflict of interest which has increased costs and restricted consumer choice.

Comparing how contact lenses and prescription drugs are prescribed and sold helps illustrate how this conflict of interest impacts consumers.

With prescription drugs, there are a number of protections which—while not perfect—help preserve competition, promote innovation, and protect the consumer.

For example, first, when a patient visits a family care physician, the patient knows the doctor is not going to sell what he or she prescribes. Second, the patient is entitled to receive a copy of the prescription, and can take it to any pharmacy the patient wishes. Third, when the patient gets to the pharmacy, he or she is often given the choice of a generic equivalent.

These protections are not available to contact lens wearers. First, eye doctors do sell what they prescribe. Second, the patient is often not entitled to, and even more often does not receive, a copy of the prescription, and may not take it to a pharmacy because the doctor is the pharmacy. Third, not only are there no generic alternatives, consumers often don't have a choice of brands.

With contact lenses, the eye doctor, not the patient, usually chooses the brand. There can be financial incentives for eye care professionals to prescribe certain brands. Many eye doctors do not prescribe brands unless they sell those brands in their store. In some cases, eye doctors prescribe private label brands sold only in their store and available nowhere else—leaving consumers to essentially pay a premium price for a generic product.

The conflict of interest in the contact lens industry catches the consumer in the middle. When a consumer decides to purchase her contacts online, she must get permission from one supplier (her eye doctor) in order to purchase from another. There is a financial disincentive for eye doctors to give competitors permission to make a sale to their customers.

Rather than update their laws and regulations to take into account the changes in how contact lenses are fit, manufactured, and sold, many states have adopted laws and regulations designed to preserve this conflict of interest and insulate eye care professionals from competition.

AN ANALYSIS OF STATE IMPEDIMENTS

1. *No Right to One's Own Prescription*

Having a contact lens wearer receive a copy of her own prescription is essential to promoting competition for replacement lenses. The prescription has been called the consumer's "ticket" to lower prices and better service.

Yet in the majority of states, consumers have no right to copies of their own prescriptions. A survey conducted by *The Detroit Free Press* indicates that consumers in the Detroit region often have a difficult time obtaining their prescriptions. Of fifty (50) optometrists surveyed, only one would release contact lens prescriptions to patients after an exam. Fifty-four (54) percent of optometry offices stated that they never release contact lens prescriptions to patients.

In some states, Americans have a right to their own contact lens prescription—but only if they ask for it. In these states, burdensome requirements are commonly used to frustrate the limited rights consumers do have. Under Illinois law, for example, consumers have a right to a copy of their prescription, but are required to request the release in writing.

Finally, in the few states where contact lens wearers do have an automatic right, that right is often not enforced.

Under federal law, every American has a right to a copy of his or her own eyeglass prescription. However, the rule setting forth this right does not extend to contact lenses because when the rule was adopted in 1978, contact lenses were custom-made. We support updating federal law to extend this rule, commonly known as the "eyeglass rule," to include contact lenses.

2. *Restrictions on Who May Sell Contact Lenses*

The laws of several states attempt to prohibit the sale of contact lenses over the Internet. In some states, these laws seek to grant monopolies to in-state eye care providers. We believe these laws are unconstitutional. Georgia law, for example, attempts to have contact lenses sold only in a face-to-face transaction with a state licensed eye care professional. Similarly, under New Mexico law, only state licensed physicians or optometrists would be allowed to sell contact lenses.

3. *Use of Prescription Lengths to Stifle Competition*

Many states do not set a minimum period for the expiration of a contact lens prescription. Absent a medically reasonable minimum standard, eye care professionals can legally write unduly short prescriptions—in some cases as short as one day—to frustrate a consumer's ability to purchase replacement lenses from other sources.

In a recent issue of *Contact Lens Spectrum*, Dr Joe Goldberg, an optometrist and Emeritus Fellow of the American Academy of Optometry described how prescription length can be used for competitive purposes:

“We can’t eliminate mail order replacement businesses, but we can use our professional ingenuity and patients’ contact lens prescriptions to challenge them.”

He went on to note that:

“Patients should obtain mail order lens replacements only during the service life of the lens prescription. Therefore, practitioners must limit the service life of a lens prescription.”

Dr. Goldberg ultimately recommends that eye care providers write prescriptions for six months, a period substantially shorter than recommended by leading professional associations. The American Academy of Ophthalmology states that, “While the optimal time limit for a contact lens prescription has not been clearly defined, most eye care professionals would recommend evaluation of the fit within two years, and the more conservative would advise one year.” Similarly, for adults aged eighteen (18) to sixty (60), the American Optometric Association suggests an evaluation every one (1) to two (2) years.

Mr. Chairman, I ask that the text of Dr. Goldberg’s article be included in the record at the end of my testimony.

On average, consumers spend approximately \$100 for an eye exam. By attempting to force consumers to come in for frequent eye exams without medical justification, eye care providers can both compel consumers to spend money on unnecessary exams and at the same time enhance the eye doctor’s ability to sell additional products.

4. Prescription by Brand

Some states require that prescriptions for contact lenses be brand specific. These laws enable eye care professionals to write prescriptions for brands sold only to the doctors that prescribe them. An increasingly popular tactic is for eye care professionals to write prescriptions for exclusive store brands available only from the prescriber. Charles Hom, an optometrist in Walnut Creek, California, described this tactic in an issue of *Contact Lens Spectrum*, stating that:

“I often do not give the patients a choice. I don’t say this is a private label lens.

I just say, ‘This is the best lens for you. It’s the one you should be wearing’”

As noted above, this tactic effectively forces consumers to buy generic lenses at premium prices.

Mr. Chairman, I ask that the text of Dr. Hom’s comments be included in the record.

5. Oversight by Self-Interested Boards of Optometry

A state-afforded right to a prescription is still no guarantee the consumer will get her prescription. Enforcement of this right is generally left to state boards of optometry, comprised largely of optometrists.

Recently, 1-800 CONTACTS and the Texas Optometry Board (“TOB”) entered into a legally enforceable agreement whereby the Board agreed to require optometrists to respond to 1-800 CONTACTS’ efforts to verify that a customer’s prescription is valid. In turn, 1-800 CONTACTS agreed to wait indefinitely for optometrists to verify prescriptions.

Texas optometrists have failed to respond to these verification attempts more than half of the time. These refusals have generated more than 10,000 written complaints to the Texas Optometry Board in the last three months alone. Neither we, nor our customers, have received any response nor do we believe any action has been taken.

California stands in marked contrast to Texas. State legislators, ophthalmologists, optometrists and consumer groups worked together to develop a regulatory system that protects consumer’s health and promotes competition. In 1998, 1-800 CONTACTS agreed with the California Medical Board to implement a passive verification method for verifying prescriptions. Under this method, 1-800 CONTACTS communicates to the eye care provider in writing the exact prescription specifications received from the customer. It also informs the eye care provider that it will complete the sale based on this prescription unless the eye care provider advises it within a specific time period that the prescription is expired or incorrect.

Earlier this week, Governor Davis signed legislation that essentially codified the passive verification agreement in place since 1998. This law was supported by the California Optometric Association which stated that the law “supports safe and responsible patient access to contact lens prescriptions” and that the law “strikes a reasonable balance between access and accountability.”

RECOMMENDATIONS: FAIR COMPETITION BENEFITS CONSUMERS

Contact lens wearers need and deserve the same protections that prescription drug purchasers and even eyeglass wearers have. Contact lenses have changed, but elements of the old system which forces consumers to purchase primarily from their prescriber have not. Without similar protections, contact lens wearers who try to purchase online and through other sources will continue to be impeded by state laws which frustrate competition and hurt consumers.

As mentioned previously, pending federal legislation would open the market to competition and benefit 35 million Americans who wear contact lenses. We urge adoption of such legislation.

Thank you for the opportunity to appear before the Subcommittee to share our views on these important issues. I would be happy to answer any questions you and the other Members of the Subcommittee may have.

PRIVATE LABEL

Using Private Label Lenses to Keep Patients in The Practice

Private label lenses, or a lens not available without a valid prescription, can help keep patients returning to the practice and safely wearing contact lenses.

JOSEPH BARR, OD: If you use private label contact lenses, how do you position those lenses in your practice? Do they help with patient retention? Do they help to keep patients from thinking about alternate sources of contact lens distribution?

BRUCE GADDIE, OD: The closest we come to a private label contact lens is the Ocular Sciences Hydrogenics UV 60. We toyed with using the Biomedics 55 under private label, and we decided that the prestige of using the brand name was better than

our private label. For the most part, using the UV 60 has thwarted 1-800 as they call, grilling our technicians as to who manufactures the Hydrogenics UV



By providing a lens that is not available without a valid prescription, I believe we're providing a safer contact lens to our patients.

—James Maul, OD

PRIVATE LABEL

60 lens. We did have some irate patients who wanted to be re-fit with lenses they could buy from 1-800. But for the most part, using the UV 60 lens and another brand has been quite successful for us.

JAMES MAUL, OD: We've run into the same problem to a certain extent. We've been using Hydrogenics 60 lenses for a while, and there have been a number of patients calling. We have been telling

They are abusing their eyes and, by providing a lens that is not available without a valid prescription, I believe we're providing a safer contact lens to our patients. If you're putting patients in the safest lens that's out there, and they choose to wear an unsafe lens, at least you are not legally liable for the abuse that can occur when they use that lens.

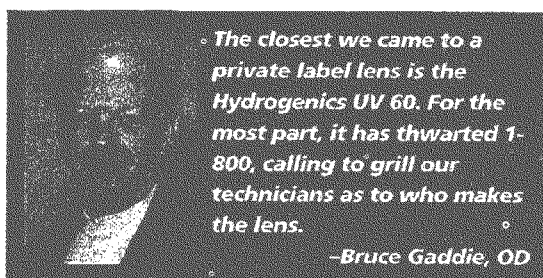
DR. BARR: Can you explain to our readers, what you mean by "This contact lens isn't available to them" or "This contact lens is available only to you."

DR. MAUL: I'm referring to the Hydrogenics lens from Ocular Sciences. It is not sold to 1-800 Contacts or on the Internet. It is provided only to doctors who actually see patients and perform examinations in their office. If a patient takes a Hydrogenics 60 prescription and fills it in one of my colleague's offices, I know that she is receiving proper eye care. If she fills out a form at 1-800 Contacts and sends it in five years after I saw her, at least as the lens is currently being marketed, it won't be available. That provides a degree of safety.

DR. BARR: So this lens is like a semi-exclusive franchise.

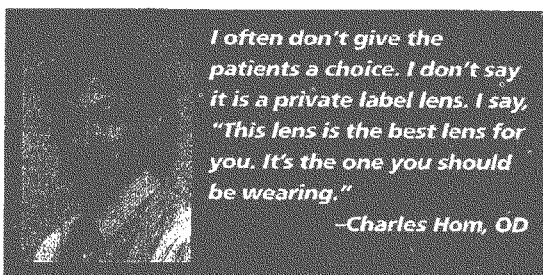
DR. MAUL: Well, in the sense that any independent private practitioner in the country can sell the lens, it's not very exclusive, but it does provide a lens that is available only with proper care.

RANDY HIEBER, OD: There is one issue I'm confused about. I started to say that the Hydrogenics was the safest lens, but then my associate came to me and said, "How can you say that to a patient when the Dk is lower than the Acuvue lens?" So I'm confused now, and maybe everybody else is in the coun-



The closest we came to a private label lens is the Hydrogenics UV 60. For the most part, it has thwarted 1-800, calling to grill our technicians as to who makes the lens.

—Bruce Gaddie, OD



I often don't give the patients a choice. I don't say it is a private label lens. I say, "This lens is the best lens for you. It's the one you should be wearing."

—Charles Hom, OD

our patients that this is the newest, most advanced technology. They can buy older technology, but this new lens is not currently available via other distributors. I tell my patients that it's the safest lens on the market. With the prescription expiration, and the inability to get this lens without a valid prescription, it ends up being a safer lens. I see patients who have not had their eyes examined in a number of years getting their contact lenses without a prescription.

PRIVATE LABEL

try, on Dk/L, Dk/T. It would be nice to get some standardization in our industry. Since I've been using the Hydrogenics lens, I like it better, but then I look at the numbers and I see we've got a Dk of 24.3 vs. 28 for an Acuvue. Can we make that statement that it is a safer lens? I'd like to ask Dr. Barr about that.

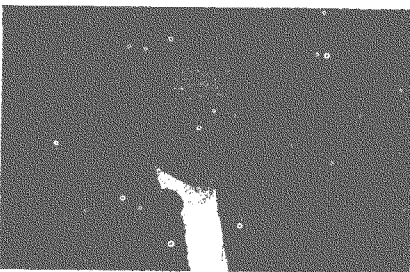
DR. BARR: Vistakon lists the 58 percent water content Acuvue 2 at Dk 28 and center thickness 0.84mm at -3.00D. OSI lists Hydrogenics 60 at 60 percent water and Dk of 24.3 and center thickness 0.07mm at -3.00D. That makes the Dk/T about equal, but remember that these measurements provide only a general idea of the actual oxygen transmissibility. There are a lot of things that go into making a safe lens. Oxygen transmissibility would be one. The quality of the lens, the reproducibility of the lens and the wettability of the lens would be others. Does anyone else want to talk about their experience with using private label lenses?

CHARLES HOM, OD: ~~We use private labeling a lot, and I think that originally we were fitting lenses like those from CIBA and Bausch & Lomb, and we would get calls from patients and 1-800 Contacts asking us for their contact lens prescriptions. I wanted to use another strategy to prevent that from happening. One of the strategies was private labeling. I didn't know of any company other than Ocular Sciences that was doing it, or is doing that now effectively. Now when patients want to order a lens, they like the particular lens that we provide. It's a private label, so they can't get it anywhere else. It makes it a lot easier for them to come back to us. If they go down to Wal-Mart or Costco or someplace like that and ask, "Do you have this lens?" Costco or Wal-Mart or 1-800 would say, "Yes, we do, but it's a different name on the box." That creates the problem within the patient's mind about whether or not it's the same lens.~~

DR. BARR: Tell us how it works. What is the lens? Tell us the process that you use in the practice to talk to patients about it, positioning and so forth.



Dr. Hom uses private label contact lenses as a strategy to prevent patients from filling their possibly expired contact lens prescriptions at alternate distributors.



Dr. Gaddie finds that choosing the Hydrogenics 60 lens has been a right choice for his practice.

DR. HOM: I often don't give the patients a choice. I don't say this is a private label lens. I just say, "This is the best lens for you. It's the one you should be wearing." It's easy because I think the Hydrogenics 60 is better than the Acuvue or the Acuvue 2. It has better handling, vision and comfort. The other lens that's really top-notch is the new toric lens from Ocular Science, the Biomedics Toric. They are comfortable, stable and have excellent vision. I don't think there's a disposable toric lens out there that can really compete with that lens, and Ocular Sciences does have that in private labeling. That makes it easy for the practitioner to prescribe the lens. **CLS**

readers' forum

BY JOE B. GOLDBERG, OD, F.A.A.O.

If You Can't Beat Mail Order Companies, Join Them

Mail order contact lens replacement is a very profitable business that poses a direct economical threat to eyecare practitioners. Immediate lens replacement and competitive prices are largely

responsible for the success of mail order and Internet companies.

We can't eliminate mail order replacement businesses, but we can use our professional ingenuity and patients' contact lens prescriptions to challenge them.

Beat Them

Patients should obtain mail order lens replacements only during the service life of the lens prescription. Therefore, practitioners must limit the service life of a lens prescription. The original lens prescription in the patient's chart and on the patient's copy should contain a statement that says:

This contact lens prescription expires on _____ 2002.

The original contact lens prescription in the patient's chart and the one given to the patient should also state:

You must have a professional eye examination to replace your contact lenses when the effective date of this prescription expires.

Each practitioner can determine the expiration date of a lens prescription. I recommend a six-month interval, which requires patients to return semi-annually to confirm the efficacy of the lens fit and receive a current lens pre-

scription. This way, the patient knows in advance that it is compulsory to return to keep the contact lens prescription current for his best interests and welfare.

It also may inhibit mail order houses from filling orders for replacement lenses once the prescription has expired.

A patient who does not comply with your procedures and obtains lenses with an expired prescription jeopardizes the position of the mail order group who fills the expired prescription, especially if the replacement pair creates a meaningful disease problem.

Patients will order contact lens replacement from mail order and Internet facilities if their lenses are comfortable, and they feel there are no obvious physiological or optical changes. Consequently, any lay facility can use a practitioner's Rx, regardless of how old it is, to replace lenses when the Rx does not have an expiration date. Without an expiration date, a patient may think his prescription never expires.

Join Them

Practitioners should try to keep an inventory of patients' lenses in the practice and duplicate the

prices and procedures of the mail order companies. This allows your practice to compete with them. What's profitable for the mail order businesses can also be profitable for you.

Let your patients and the general public know that you supply the identical services furnished by mail order and Internet companies, but locally and for immediate delivery without postage and handling charges.

You can also furnish a service contract for replacement contact lenses that is similar to those of mail order companies. The contract should state the reduced cost of a contact lens replacement. You can collect your service contract fee in advance.

Although the service life of your patient's contact lens prescription is six months, you can make the service contract for either six months or one year. If you make it for one year, make sure it states that the coverage is for contact lenses whose expiration dates have not expired.

Record the service contract in your computerized database so you can provide replacement lenses to your patients directly from your inventory.

If the mail order and Internet groups can create a profitable contact lens replacement business, so can you! **CLS**

Dr. Goldberg is an Emeritus Fellow of the American Academy of Optometry and is a Diplomate in the Section of Contact Lenses.

Mr. STEARNS. I thank the gentleman.
Mr. Cruz, welcome.

STATEMENT OF TED CRUZ

Mr. CRUZ. Thank you, Mr. Chairman.

Mr. STEARNS. We'd be glad to put your documents as part of the record. Just give them to the reporter.

Mr. CRUZ. Thank you. I'm Ted Cruz. I'm the Director of Office of Policy Planning at the Federal Trade Commission and I'm pleased to be here today to present the Commission's testimony. On behalf of the Commission, I'd like to thank the subcommittee for addressing this important issue and thank Chairman Stearns in particular for his leadership in addressing this issue which we believe has the potential to significantly impact the future of e-commerce.

E-commerce has the potential to transform many relationships in our economic society and the economic boom that e-commerce has begun to bring in even with economic downturns promises to be very significant.

In addition, the internet offers enormous personal freedom. What is interesting is that when many public policy analysts, when many policymakers think of the internet and they think of regulatory and legal issues concerning the internet, they often think of the very important issues concerning taxation and privacy, both of which are critically important. But in addition to that, there is the entire set of issues we are addressing here today, a set of issues that many analysts have not focused on how those issues are potentially impacting e-commerce. And in particular, some observers have suggested that what we are seeing in the e-commerce sphere is an old pattern repeating itself. And that's a pattern of existing businesses appealing to government regulators for help to be an ally against potential new entrants, against potential new threats.

And many of these commentators have suggested that what is happening when State and local regulations are being extended to e-commerce is exactly that.

Indeed, Mr. Atkinson and his two very comprehensive reports that were issued on this analogy that pattern to what happened in 1919 over 80 years ago when what was then the powerhouse lobby association of this town, the Horse Association of America, along with their traditional partners, the Master Horseshoer National Protection Association and the National Hay Association, lobbied very effectively State and local governments to prohibit parking automobiles on public streets and they explained at the time that everyone knew public streets are where horses belong and these new fangled automobiles should not be crowding them off.

That concern, the concerns that there were potential barriers to e-commerce led the Commission to create in August of last year an Internet Task Force which is a task force that has spent the past year studying and examining the possibility of these barriers. The task force has worked within the Commission to prepare four different comments that the FTC has filed that touch on these issues. The first was a staff comment that the staff of the Federal Trade Commission filed in the State of Connecticut before the Connecticut State Board of Opticians.

There, the State Board of Opticians is considering additional regulations to the internet sales of contact lenses. And the FTC staff submitted a comment urging that as that Board considered those regulations, it also considered the effect on competition and that, while consumer protection concerns should be paramount, that those concerns should be protected in a manner that also allowed for competition so the consumers could receive the benefit of competition and the lower prices as an increased convenience that competition can bring.

In addition, the Commission filed joint filings in the State of North Carolina and the State of Rhode Island, urging that those States not adopt proposals to require the physical presence of an attorney for every real estate closing and every real estate refinancing in the State. And finally, the Commission filed an amicus brief just this past money in Federal District Court, concerning litigation in the State of Oklahoma brought by an internet casket seller who is opposing restrictions by the State Funeral Board that only licensed funeral directors can sell a casket in the State of Oklahoma. And in that brief, the Commission argued that the justification that the Oklahoma Board was asserting, namely that it was defending the FTC's funeral rule, mischaracterized the FTC's funeral rule because the purpose of the funeral rule was to allow and facilitate consumer choice and to assure through that choice that consumers were fully protected.

As the Chairman mentioned, we're holding a workshop, October 8 through October 10, where we expect to hear panelists address all these issues and we look forward to learning more about the impacts on both sides of the potential impact of consumers of these possible restrictions.

Thank you.

[The prepared statement of Ted Cruz follows.]

PREPARED STATEMENT OF TED CRUZ, DIRECTOR, OFFICE OF POLICY PLANNING,
FEDERAL TRADE COMMISSION

I. INTRODUCTION

Mr. Chairman, I am Ted Cruz, Director of the Office of Policy Planning of the Federal Trade Commission.¹ I am pleased to appear before the Subcommittee today to testify on behalf of the Commission regarding possible "State Impediments to E-commerce." The Commission thanks the Subcommittee for addressing this important issue, which may have a significant impact on our nation's economy and on the growth of e-commerce. In particular, the Commission would like to thank Chairman Stearns for his leadership in this area, and for his foresight in addressing an issue that is critical to the future growth of e-commerce.

The Internet boom, heralded by many as the next industrial revolution, is transforming society before our eyes. Even with recent economic downturns, it has immense potential as an engine for commerce. Moreover, the Internet also offers consumers enormous freedom. There are, of course, important policy disputes about taxation and privacy legislation. But, aside from those disputes, many think of the Internet as a virtually unfettered free market, a place spawning creativity and innovation and self-expression.

Some observers have suggested, however, that this perception of unfettered competition may not be completely accurate. Instead, these observers assert that existing businesses are seeking to use government authority to impede new entrants from competing. In a number of instances, and in a number of states, pre-existing regulatory regimes have been extended to the Internet, and it bears examining

¹ The views expressed in this statement represent the views of the Commission. My oral statement and responses to questions you may have are my own and do not necessarily reflect those of the Commission or any individual Commissioner.

whether particular regimes are pro-competitive and pro-consumer, or whether they eliminate cost savings or convenience without sufficient benefits to justify those losses.

II. FTC EFFORTS TO FOSTER ONLINE COMPETITION

In response to these concerns, in August 2001, the Federal Trade Commission formed an Internet Task Force to evaluate regulations and business practices that could potentially impede e-commerce. The Task Force grew out of the already-formed State Action Task Force, which had been analyzing the antitrust doctrine concerning state regulations generally, and out of the FTC's longstanding interest in the competition aspects of e-commerce.

Over the past year, the Task Force has met with numerous industry participants and observers, including e-retailers, trade associations, and leading scholars, and has reviewed the relevant literature.² The Task Force has been examining state regulations, often enacted for purposes unrelated to competition, that may have the effect of aiding existing bricks-and-mortar businesses at the expense of new Internet competitors. Of course, these regulations may be justified by consumer protection interests or other sound public policy. The Task Force also is considering whether and to what extent private companies may be curtailing e-commerce by employing potentially anticompetitive tactics, such as by collectively pressuring suppliers or dealers to limit sales over the Internet.

To further these efforts, and the important inquiry of the Subcommittee today, in October the FTC will host a public workshop that will focus on two types of possible barriers to e-commerce. One type consists of business conduct barriers that may arise when private parties employ potentially anticompetitive tactics, such as when suppliers or dealers apply collective pressure to limit online sales. The other type consists of state and local regulations, such as occupational licensing and physical office requirements, that may have pro-consumer and pro-competition goals, but that nevertheless may restrict the entry of new Internet competitors or hamper their operations.

The workshop will take place at the FTC from October 8-10, 2002, and will include consumer advocates, industry representatives offering a variety of perspectives, academics, and state government representatives. The FTC is actively seeking perspectives and data from both supporters and critics of these possible restrictions, to understand better their full impact. We have four principal goals for the workshop: (1) to enhance the FTC's understanding of these issues, (2) to help educate policymakers about the effects on competition and consumers of restrictive state regulation, (3) to help educate private entities about the types of business practices that may or may not be viewed as problematic, and (4) to learn of additional avenues to promote competition through e-commerce.³

III. ONLINE COMPETITION IN DIFFERENT INDUSTRIES

Each of the industries to be addressed at the FTC workshop has enormous potential for providing goods and services to consumers over the Internet and may be beginning to face significant barriers to expansion. A review of several of the industries follows.

A. Retailing

E-commerce retail sales continue to expand rapidly. For example, in the second quarter of 2002, retail e-commerce sales increased 24.2 percent, up to \$10.2 billion, from the second quarter of 2001.⁴ In contrast, all retail sales for the second quarter increased only 2.5 percent from the second quarter of 2001.⁵

Nonetheless, in some instances we have seen attempts to limit e-retailing through conduct that raises antitrust issues. For example, in the late 1990s, a group of 25 Chrysler dealers in the Northwest threatened to refuse to sell certain Chrysler models, and to limit warranty service, unless Chrysler limited its supply of cars to an Internet seller. In 1998, the FTC filed an administrative complaint against the deal-

²In particular, the Progressive Policy Institute wrote two comprehensive reports analyzing the trend toward potentially anticompetitive efforts to restrict e-commerce. See Robert Atkinson, *The Revenge of the Disintermediated* (Jan. 2001) (first report of the Progressive Policy Institute) ("First PPI Report"); Robert Atkinson and Thomas Wilhelm, *The Best States for E-Commerce* (Mar. 2002) (second report of the Progressive Policy Institute) ("Second PPI Report").

³See 67 Fed. Reg. 48,472 (2002). More information about the workshop is available at the homepage for the workshop, <http://www.ftc.gov/opp/ecommerce/anticompetitive/index.htm>.

⁴United States Department of Commerce News, 2nd quarter 2002 release, Aug. 22, 2002, available at <http://www.census.gov/mrts/www/current.html>.

⁵*Id.*

ers.⁶ The complaint alleged that the dealers had formed an association B Fair Allocation System, Inc. (“FAS”) B for the purpose of restricting the number of vehicles available to competing dealers marketing, and offering lower prices, over the Internet. The matter was settled by a consent order which prohibited FAS from participating in, facilitating, or threatening any boycott of, or concerted refusal to deal with, any automobile manufacturer or consumer.⁷

Additionally, other reports B some published and some anecdotal B suggest that some distributors may have applied pressure to discourage their suppliers from selling online directly to consumers.⁸ We intend to examine whether, and in what circumstances, this conduct may raise antitrust issues, or may address legitimate concerns about free riding and channel conflict. We hope to develop a better understanding of the conduct, and reasons for or against limiting retail sales over the Internet.

B. Contact Lenses

Competition has increased dramatically in the eye care marketplace since the 1970s. The most recent step in the evolution of this market is the development of stand-alone sellers of replacement contact lenses. Such firms do not fabricate lenses or fit them to the eye; they sell only replacement lenses for which the customer has already been fitted by an eye care professional. Unlike other eyewear sellers, their business consists simply of shipping to customers lenses that come from the manufacturer in sealed boxes labeled with the relevant specifications. Most of these businesses are located in a single state but ship orders to customers nationwide.

On one hand, some studies suggest that such sellers may be able to provide consumers with substantial cost savings and with greater convenience from delivering lenses to the consumer’s door. These factors may also induce consumers to replace their lenses more often, which could have significant ocular health benefits.

On the other hand, some observers believe that online sales of contact lenses may threaten consumer health. For example, online purchases may reduce the number of times that a consumer visits an eye doctor. Some also suggest that state licensing and an in-state presence is necessary to allow a state to regulate effectively in order to maintain quality and truthfulness. Some states have enacted requirements that significantly restrict competition from online lens providers. In other states, regulatory boards are currently considering new requirements that might similarly restrict Internet sales.

In March 2002, the FTC filed a staff comment before the Connecticut Board of Examiners for Opticians, which is currently considering whether to require stand-alone sellers of replacement contacts to obtain Connecticut optician and optical establishment licenses. Working with the Connecticut Attorney General’s Office, the FTC staff comment argued that such a requirement “would likely increase consumer costs while producing no offsetting health benefits,” and that such a requirement in fact “could harm public health by raising the cost of replacement contact lenses, inducing consumers to replace the lenses less frequently than doctors recommend.”⁹

C. Real Estate / Mortgages / Financial Services

Consumers can now receive many professional and financial services online. Through the Internet, consumers can get advice from real estate agents, finance a house, or buy stocks through a broker. In addition to convenience, online real estate, mortgage, and financial companies have the potential to offer lower rates because, without a bricks-and-mortar infrastructure, they may have lower costs.

A number of states have adopted regulations that may affect the provision of these services by online, out-of-state firms. In several states, companies must maintain an in-state office as a condition for licensing if the company makes, brokers, or services residential mortgage loans. Many other states require online mortgage brokers to get in-state licenses. Many of these regulations are designed to protect

⁶See Complaint in *Fair Allocation System*, No. C-3832 (1998), available at <http://www.ftc.gov/os/1998/9810/9710065cmp.htm>.

⁷See Consent Order in *Fair Allocation System*, No. C-3832 (1998), available at <http://www.ftc.gov/os/1998/9810/9710065.do.htm>.

⁸E.g., Doug Bartholomew, *E-Commerce Bullies*, *industryweek.com*, Sept. 4, 2000, at 51. See also First PPI Report at 14 (noting that, in a survey of 42 retail and manufacturing companies, 74 percent of the manufacturers reported that they do not sell online due to worries about how it might affect their other retail channels).

⁹FTC Staff Comment Before the Connecticut Board of Examiners for Opticians (Mar. 27, 2002) available at <http://www.ftc.gov/be/v020007.htm>. This comment expresses the views of the Bureau of Consumer Protection and the Office of Policy Planning of the Federal Trade Commission. The comment does not necessarily represent the views of the Commission or of any individual Commissioner. The Commission did, however, vote to authorize the Office of Policy Planning and the Bureau of Consumer Protection to submit the comment.

consumers from unscrupulous practices, and may indeed prove substantially beneficial to consumers. They may also, however, have the secondary effect of insulating local businesses from wider competition, or of allowing only national mortgage firms that already have physical offices in all states to sell online in all states.

The Commission and the Department of Justice have expressed concerns regarding one type of state regulation of these services. The agencies jointly filed comments opposing proposals in both North Carolina and Rhode Island to require attorneys to be physically present for all real estate closings and refinancings. These regulations could seriously impede online mortgage lenders, who often rely on lay closers rather than on attorneys with a physical presence in the state. In letters to the North Carolina State Bar and the Rhode Island Legislature, we argued in favor of consumer choice, citing empirical evidence showing that non-lawyer closings can save consumers significant amounts of money, sometimes up to \$400 per transaction, and can increase convenience for consumers, because non-lawyers often are more willing to travel and meet consumers after work.¹⁰

FTC/DOJ Letter to the Rhode Island House of Representatives re: Bill Restricting Competition from Non-Attorneys in Real Estate Closing Activities (Mar. 29, 2002) available at <http://www.ftc.gov/be/v020013.pdf>.

D. Casket Sales

Because mark-ups on caskets can be significant, online casket purchases can potentially save consumers substantial sums of money. Additionally, online casket sellers also may be able to offer consumers a greater variety of choices, such as individualized caskets. Some states, however, require that casket purchases be made only through a licensed funeral director at a funeral home.

On September 5, 2002, the Commission filed an amicus brief in federal district court in the matter of *Powers v. Harris*,¹¹ in which an Internet-based casket seller challenged a state law that requires all sellers of funeral goods to be licensed funeral directors. The Commission's brief stated that the FTC's Funeral Rule was adopted, in part, to open casket sales to competition from sellers other than funeral directors and that the Rule protects consumers by promoting competition among providers of funeral goods, including independent online casket retailers.¹²

E. Automobiles

Automobiles represent one of the biggest investments for many households, both in terms of their purchase price and their importance to a family's daily life. A group of Yale economists have concluded that consumers who use Internet purchase referral services to buy a car pay on average 2% less than consumers who do not.¹³ Moreover, the Consumer Federation of America ("CFA") projects that if the restrictions currently imposed on Internet auto sales were removed, savings of 10% per vehicle are achievable over time.¹⁴ At today's prices, CFA estimates that this would amount to savings of \$2,500 per car.¹⁵ Yet another study has concluded that expanded online auto purchases would especially benefit women and minorities.¹⁶

On the other hand, many dealers argue that they have legitimate reasons for concern about manufacturer Internet sales. The National Automotive Dealers Association argues that franchise laws protect consumers against unscrupulous manufacturers.¹⁷ Dealers also argue that Internet sales unfairly undermine their businesses by letting online sellers "free ride" off the dealers' personal services. Further examination of these concerns would be valuable. Currently, all 50 states prohibit manu-

¹⁰ FTC/DOJ Letter to the Ethics Committee of the North Carolina State Bar re: State Bar Opinions Restricting Involvement of Non-Attorneys in Real Estate Closings and Refinancing Transactions (Dec. 14, 2001) available at <http://www.ftc.gov/be/V020006.htm>; Second FTC/DOJ Letter to the Ethics Committee of the North Carolina State Bar (June 11, 2001) available at <http://www.ftc.gov/os/2002/07/nonattorneyinvolvement.pdf>;

¹¹ *Powers v. Harris*, No. Civ. 01-445-F (W.D. Okla. filed Mar. 14, 2001).

¹² FTC Amicus Brief in *Powers v. Harris* (August 29, 2002) available at <http://www.ftc.gov/os/2002/09/okamicus.pdf>.

¹³ Fiona Scott Morton, Florian Zettelmeyer, and Jorge Silva-Risso, *Internet Car Retailing*, 49 J. Indus. Econ. 501, 502 (2001).

¹⁴ Mark Cooper, *A Roadblock on the Information Superhighway: Anticompetitive Restrictions on Automotive Markets* 38 (Feb. 2002) available at <http://www.consumerfed.org/internetautosales.pdf>.

¹⁵ *Id.* at 37.

¹⁶ Fiona Scott Morton, Florian Zettelmeyer, and Jorge Silva-Risso, *Consumer Information and Price Discrimination: Does the Internet Affect the Pricing of New Cars to Women and Minorities?* (Oct. 2001) available at <http://www.yale.edu/law/leo/papers/scottmorton.pdf>.

¹⁷ First PPI Report at 7.

facturers and online sellers without a franchise presence from selling new cars directly to consumers.

F. Wine Sales

Wine is a good example of how the Internet can permit fundamentally different business models to flourish. Through the Internet, many smaller vineyards, with limited distribution networks, can now market their wines to consumers around the country.¹⁸ Consumers also can potentially save money by buying online, avoiding markups by wholesalers and retailers.¹⁹

On the other hand, many states limit or prohibit direct wine sales over the Internet. Under the common “three tier” distribution system, many states require that wine pass through a wholesaler or a retailer before reaching the consumer. These states, and many commentators, contend that the distribution system furthers the state’s interest in taxation, advances the Twenty-First Amendment’s important public policy goal of temperance, and helps prevent alcohol sales to minors.

Lawsuits are pending in at least seven states regarding the direct shipment of wine. In Texas,²⁰ North Carolina,²¹ and Virginia,²² federal district courts recently struck down state restrictions on direct shipment of wine on dormant Commerce Clause grounds, while in Florida²³ and Michigan,²⁴ federal district courts upheld such restrictions. All these decisions currently are on appeal. In New York²⁵ and Washington state,²⁶ lawsuits are pending in federal district courts.

IV. ADDITIONAL INDUSTRIES

At the public workshop, the Commission will also be examining other industries that may raise similar issues. Those industries include the following:

- Healthcare, Pharmaceuticals, and Telemedicine;
- Cyber-Charter Schools;
- Auctions; and
- Online Legal Services.

The Commission expects to learn more about the existence of and relative costs and benefits of any restraints on online competition in these industries.

V. CONCLUSION

Thank you for this opportunity to share our views on competition and Internet commerce. We look forward to working with the public and with the Subcommittee in understanding these issues and in helping to give consumers the full benefits of online commerce.

Mr. STEARNS. I thank the gentleman. I’ll start with my questions.

President Ronald Reagan was asked what book out of all the books you’ve ever read has influenced you the most and I believe he said Frederick Bastiat’s book on economics. There’s a vignette in there in which the candlemakers’ union is working as hard as they can to prevent the light bulb from becoming the omnipresent use in the society and how the candlemakers make all their arguments to convince the government to prevent their industry from becoming obsolete. And Mr. Bastiat goes to great length to show how successful these candlemakers are and all the ridiculous arguments they make, but this goes to the heart of the problem.

In picking up your report, Mr. Atkinson, you have Joseph Schumpeter in which he says “the resistance which comes from interests threatened by an innovation in the productive process is not likely to die out as long as the capitalist order persists.”

¹⁸ See, e.g., Second PPI Report at 21.

¹⁹ *Id.*

²⁰ *Dickerson v. Bailey*, 212 F.Supp.2d 673 (S.D. Tex. 2002).

²¹ *Beskind v. Easley*, 197 F.Supp.2d 464 (W.D. N.C. 2002).

²² *Bolick v. Roberts*, 199 F.Supp.2d 397 (E.D. Va. 2002).

²³ *Bainbridge v. Bush*, 148 F.Supp.2d 1306 (M.D. Fl. 2001).

²⁴ *Heald v. Engler*, 00-CV-71438-DT (E.D. Mich. Sept. 28, 2001) (unpublished).

²⁵ See *Swedenburg v. Kelly*, 2000 WL 1264285 (S.D. N.Y. Sept. 5, 2000).

²⁶ See *Mast v. Long*, No. CS-01-00298 (E.D. Wash.).

So I guess this has been an age-old problem and obviously the light bulb succeeded and the candlemakers went into a different marketing strategy. Folks have mentioned my bill, H.R. 2421 as a prototype that we could use on a national level. Mr. Cruz, besides the examples of the fair allocation system incorporated in your testimony, has the FTC's internet task force found other cases where brick and mortar retailers have collaborated to restrict competition from e-commerce and if so, elaborate?

Mr. CRUZ. We have been actively looking for other instances. It's a situation where there are anecdotal reports, but there is little hard evidence that we have found. The Fair Allocation Systems case, as you mentioned, was a case the Commission brought and ultimately settled with a consent decree where there was—the complaint alleged a horizontal threatened boycott of Chrysler dealers against Chrysler if it continued to sell to a dealer that was selling over the internet.

We are in the process of looking for similar instances. We are certainly concerned that they are occurring, but much of that depends upon consumer complaints and finding evidence of this conduct and so we're looking for that.

Mr. STEARNS. Mr. Atkinson, so you're advocating in your paper, you suggest that we in Congress could enhance e-commerce by creating "an industry by industry basis uniform national standard that enable e-commerce competitors to sell more easily in all 50 States."

This would be quite difficult, wouldn't it, to go industry by industry to do this?

Mr. ATKINSON. Well, first of all, most industries aren't burdened by these laws because they're not regulated at the State level. There are a small number and I don't know the number, let's say 25 where this is a problem and many of those are—have somewhat ancillary regulations at the Federal level.

Mr. STEARNS. Is Florida one of those States?

Mr. ATKINSON. We did a report, the best States for e-commerce and we ranked the States—

Mr. STEARNS. Why don't you give the top five States that are best.

Mr. ATKINSON. The best five States in order were Oregon, that's No. 1, Utah, Indiana, Louisiana and Iowa.

Mr. STEARNS. Where is California?

Mr. ATKINSON. Believe it or not, California was 47th and this is one of those surprises to us where California—

Mr. STEARNS. That's where Silicon Valley is.

Mr. ATKINSON. When it comes to e-commerce production, they're great, but California has an enormous array of legacy laws that make it difficult for California consumers to buy on line.

Mr. STEARNS. So Mr. Radanovich should move his winery to Oregon?

Mr. ATKINSON. Exactly.

Mr. STEARNS. Where is Florida?

Mr. ATKINSON. Florida is, I don't have the numbers here. It looks like they're about 35th. So a little bit of work to do.

Mr. STEARNS. Okay.

Mr. ATKINSON. These are really for any State—I talked to States and they said how can we move up and I said you can be No. 1 next year, all you have to do is repeal these protectionist laws next session. It's not all that difficult although politically we can say it's a little bit more difficult.

Mr. STEARNS. I have one more question. Mr. Cohen, you sort of indicate that H.R. 2421, the bill I have, that it might be a prototype. Do you think we can craft a bill to preempt other aspects of State regulation affecting e-commerce just in one fell swoop? That's what you think we can do?

Mr. COHEN. It would my life much easier. It would make our lawyers' life—

Mr. STEARNS. You wouldn't have the balkanization of all these 50 States and all their laws.

Mr. COHEN. They are amazing, the vulcanization. The packaged seed regulations, the event ticket regulations. I mean we've identified 17 different States that regulate the resale of tickets and innumerable number of localities and the absurdity is that certain States allow the resale of tickets for \$1 over the listing, the face price. Certain other States allow it for \$2. Certain other States, \$3, some \$4, some \$5. Just the absurdities are amazing. So what we would probably recommend is a national standard and then work with people that may potentially claim that there are some reasons to allow States to regulate in some areas.

The better thing is a national standard as the default and then work with industries that have a reasonable expectation for some State regulation.

Mr. STEARNS. Are there any industries you want to point fingers at this morning as middlemen?

Mr. COHEN. Well, we do point out one of them is the auction regulators.

Mr. STEARNS. Any others besides the one in North Carolina?

Mr. COHEN. Oh, there are many, many other States that regulate auctions that have similarly ridiculous standards for on-line auctions. Other industries that we have confronted are travel packages, very difficult to deal with.

Mr. STEARNS. Mr. Zeidner, do you think just a simple GAO study would be helpful in exposing many of the issues that you present today since we're not going to legislate too much this year. We're going to be through shortly. Even if we come back in December, this will be difficult to pass, but I mean, maybe in your particular case would help set the stage with a GAO audit on this.

Mr. ZEIDNER. I agree. I think any type of investigation that can be done into first the threshold question of the framework that we find ourselves in of a person that prescribes something and sells the same thing they prescribe should be looked at. Although we also advocate and think that at the very least, people should have the right to their prescription which they don't have right now, but we do think there needs to be a comprehensive study because some of these things that I read to you, that's just the tip of the ice berg. There's a lot of different ways that competition can be thwarted.

For example, even if you do get a copy of your prescription, let's say that that's a Federal law, what if you get a copy of a prescription that's for the Zeidner 55 because I have a big chain of contact

lens stores and you can only buy it from me. It really hasn't done you a whole lot of good.

Mr. STEARNS. Okay, my questioning is compete. Mr. Towns?

Mr. TOWNS. Thank you very much, Mr. Chairman. Let me begin with you, Mr. Sloane.

Mr. SLOANE. Yes sir.

Mr. TOWNS. How would you enforce a law that requires proof of age at the time of delivery? Would UPS, FedEx? Who would be responsible for enforcing such a law?

Mr. SLOANE. Well, in fact, the Congress did pass a law 2 years ago that allows States, gives States additional authority to be able to go after shippers or others that violation State law requirements for adult signatures, things of that nature. So there is an ability to enforce it, no question.

Mr. TOWNS. Let's use New York as an example. Say a State like New York would lose, as a result of protectionist policy, do you have those kind of figures?

Mr. SLOANE. Well, I don't have those kind of figures. We can probably work it out and try to give you something.

It's really more a question of the availability of the products. In other words, in a market place like New York, you've got a couple of major wholesalers and those wholesalers represent a select range of the top brands that you're always accustomed to, but good luck going around in the State of New York and trying to find retailers, for example, that carry wines that are produced in New York. And the reason is they can't get into the three-tier system. Wholesalers just don't want to carry those products. The selection issue is really the problem for us, more than a cost issue, but there are certainly cost implications as well.

Mr. TOWNS. Thank you. Mr. Zeidner, are you saying my concern in reference to contact lenses, actually something I shouldn't have to be concerned with?

Mr. ZEIDNER. No, I agree with you completely. In fact, I think it's a well-founded concern. We really would like to have a relationship with optometrists like pharmacies have with doctors. The problem we have is we're essentially, when we verify a prescription, maybe it would be helpful to you to explain how we go about selling contact lenses. When a person calls us they either have their prescription in their hand or their prescription is written right on the side of the box.

There's basically three parameters. The base curve, the diameter and the power. So they can read us their prescription off the box. What we do is before we process an order, we have to have the doctor's name and phone number. We call on every single order during business hours to ask the doctor if this is correct, if the prescription information we've been given is correct. We wait a reasonable period of time and if we hear from the doctor, we cancel the order if he says it's expired, we don't ship it. If we hear from the doctor after we've shipped the order, we send a copy of what the doctor sent to us to the consumer and say you need to heed what your doctor said.

The problem that we have is, as you can imagine, whenever you ask a competitor for the permission to make a sale, usually they're going to greet that with no response or try to stop us from doing

it. So I think there is a valid health concern and we wish it was more like a pharmacy/doctor relationship. Unfortunately, we work within the framework where the person that prescribes also sells.

Mr. TOWNS. Mr. Sloane, most opponents of wineries to sell liquor to consumers argue they are protecting their citizens against the evils of alcohol. Tell me what safeguards exist, that you would give say to shipping to a person alcohol. You do have people who will say the reason, in our State, we have this law is we're going to protect them against sin. What do you say to people?

Mr. SLOANE. There are certainly safeguards in the system to prevent underage people from buying alcohol over the internet. For one thing, somebody has got to use a credit card which there are verifications involved and that secondarily, there is typically an adult signature that's required to the product.

Shippers don't simply leave a box of wine at somebody's doorstep and walk away. So there are verifications and as far as protection citizens against the evils of alcohol, anyone over the age of 21 is allowed to drink and it's a matter of personal choice and so that would be something that individuals would have to decide on their own, but it's certainly a legal product and people can go ahead and buy alcohol locally or through the internet.

Mr. TOWNS. Mr. Cohen, let me just ask you quickly, take us through the Illinois State Auction Statute, how the State tried to alter it and how—what they had proposed would have affected eBay business. Could you take us through the whole process very quickly?

Mr. COHEN. In September 1999, the Illinois legislature added three words "and the internet" to their auction licensing act. They have been trying to apply that and issue the regulation since January 2000. We started to work with—we've been working with them the whole time and they continued and especially at the beginning of this year, had decided to issue regulations that would have required eBay and all of eBay sellers who did one of three things, either had physical property in Illinois, either or they were sellers based in Illinois or they offered items that Illinois residents could purchase, would have to get licenses for the State of Illinois to do their business on eBay.

What we were confronted with, the issuance of the regulations and the issuance of notices that we were out of compliance, we contacted the Illinois regulators and asked to work with them to amend the statute to change the statute from a licensing act that would have basically ended our business in Illinois and the businesses of our users in Illinois and move to a registration scheme in which the only registration requirement is for eBay to file a registration statement, a 1-page statement with the State of Illinois that tells Illinois residents who they're doing business with.

Now the problem is if they had been successful and enforced the law, we had calculated that in their 1.5 million users of eBay in Illinois that do approximately \$300 million in sales, transacting in Illinois, of that there are more than 3,300 businesses in Illinois that sell more than \$1,000 a month on eBay and of those 3,300 businesses, more than three quarters of them are people that make less than \$75,000 a year. So they're the small business people of the country who would have been the most impacted by the licens-

ing requirements. And that's why we fought and worked with them to come up with a better scheme that we think is a model for nationwide adoption.

Mr. STEARNS. I thank the gentleman. What we're going to try to do is finish up the hearing with the gentlemen from California and New Hampshire and then we'll conclude the hearing because we have three votes and I didn't want to keep you back here.

The gentleman from California.

Mr. RADANOVICH. Thank you very much. On the issue of underage drinkers buying products over the internet, it's a possibility for something like that to happen, but the fact of the matter is it's far, far easier for an underage drinker to get alcohol any other way and so it's just an option. That's why there's been no sign of abuse, in California, where it's legal to ship interstate all the time.

Mr. Cruz, I really am interested in the examples of the candle and the horses. Over the years, we've obviously gone through these kinds of things before. How does this happen? Can you kind of chart a process through the future very briefly? How does this happen on issues of wine and the three-tiered system and shipping regulations? Do these things just take care of themselves over time? I noticed, Mr. Cohen, you're here with eBay, that eBay is arranging or sells wine over the internet and has made arrangements in 35 States where usually right now there is only about 12 or 13 reciprocal States where that's possible to happen through legal maneuvers within the States to be able to make it more available. Is that how this is going to happen?

Mr. CRUZ. I think the evolution of technology and of commerce is a difficult thing to stop. I think historically it's possible to slow it down and whenever there is change, there are people who are improving and people whose situation is not necessarily improving and those that stand to lose from the change, often can be expected to try to slow it down.

But in terms of how these ultimately are addressed and let me throw a caveat that I think is important from the Commission's perspective, we are still very much in the evaluating mode. We are concerned that these restrictions in many of these industries are limiting competition, but we also understand that many of these restrictions have important consumer protection justifications and so we're trying to hear from experts about the various aspects of it and understand the aggregate impact, but often how it's changed is simply by light being shined on it and an understanding of what are the impacts on consumers and that hopefully in this instance will lead policymakers to move toward a situation that protects consumers more and promotes greater competition.

Mr. RADANOVICH. Thank you.

Mr. STEARNS. The gentleman from New Hampshire.

Mr. BASS. Very briefly, Mr. Cruz, is internet commerce interstate in your opinion inherently interstate?

Mr. CRUZ. Obviously, it doesn't by definition have to be. I mean one can, you know, you and I can engage in commerce within the same State over the internet, but by its very nature internet commerce is something that when it approaches any scale at all tends to be interstate and often international.

Mr. BASS. Ergo, the only entity nationally that's going to be able to regulate is Congress. I just want to know if it would be all right if we have any further questions you folks would be willing to follow up in writing? I yield back.

Mr. STEARNS. I thank the gentleman. We want to thank the witnesses. We are going to adjourn the subcommittee and thank you again for your attendance. The subcommittee is adjourned.

[Whereupon, at 11:08, the hearing was adjourned.]

[Additional material submitted for the record follows:]

WINE AND SPIRITS WHOLESALERS OF AMERICA
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The Honorable CLIFF STEARNS, *Chairman*,
Commerce, Trade & Consumer Protection Subcommittee
Committee on Energy & Commerce
U.S. House of Representatives

DEAR CHAIRMAN STEARNS: I want to thank the Chairman and members of the Subcommittee for giving me the opportunity to present testimony about a remarkable American success story known as the three-tiered alcohol distribution system. I represent the Wine and Spirits Wholesalers of America, Inc. (WSWA), a national trade organization and the voice of the wholesale branch of the wine and spirits industry. Founded in 1943, WSWA represents more than 400 privately held, family owned and operated companies in 44 States, the District of Columbia, and Puerto Rico that hold State licenses to act as wine and/or spirits wholesalers.

I don't know how many members of the Subcommittee have visited package store or tavern in your districts recently, but if you have, you witnessed one of the great consumer success stories of the 20th century. In virtually every store and tavern, the shelves are stocked with literally hundreds of quality brands of wine, spirits and beer.

What is even more remarkable, considering the plethora of state and federal regulations and taxes applied these products—a burden which, I would add, at the federal level benefits imported spirits at the expense of domestic spirits, and which WSWA is working with Congress to change—the price for beverage alcohol products has remained consistently affordable for the average consumer over the past 69 years. In fact, in many cases the pre-tax price has even declined when adjusted for inflation.

The point I want to stress is that, for the average American consumer, there has never been better quality, variety and affordability in the beverage alcohol marketplace. I would venture to say that the majority of the consuming public is quite satisfied—or maybe even more accurately overwhelmed—with the quality and selection of brands available to them just around the corner from their house. In fact, even if a consumer opted to drink a different bottle of wine each-and-every day, it would take two years to sample the total number of wines available in the average marketplace.

The overwhelming success, both in terms of value and variety, of today's marketplace can be traced back to the decision by state lawmakers at the end of Prohibition to establish the three-tiered system for the distribution of beverage alcohol—a decision which was theirs to make as a result of the ratification of the 21st Amendment in 1933.

The 21st Amendment is unambiguous in its enumeration of power to the states to regulate the importation and shipment of alcohol across its borders. And no Supreme Court or appellate court decision interpreting that amendment over the past 69 years has ever diminished that authority. The simple fact is, as noted by respected jurist Frank Easterbrook in a recent 7th Circuit opinion upholding Indiana's right to determine and regulate the channels of distribution, alcohol is not cheese—nor contact lenses—nor even auction sales for that matter.

Principal among the reasons that the three-tiered system was established was consumer protection; it was determined that there should be an intermediary separating the supply and retail tiers to ensure that large suppliers with market power did not dominate individual retailers to the exclusion of other suppliers who might try to break into the market. In other words, the imposition of a mandatory wholesale tier served to blunt monopolistic supplier tendencies that had prevailed prior to Prohibition.

However, the beauty of the three-tiered system is not limited to the benefits it obviously confers on consumers and the marketplace, or in its operation as a hedge against monopolistic supplier tendencies. The three-tiered system also functions as a partner with state regulatory systems that are designed to promote the core 21st Amendment concerns of the state—ensuring orderly market conditions, promoting temperance, including keeping alcohol out of the hands of minors—and collecting tax revenue. By requiring that every drop of alcohol pass through the licensed three-tiered system, states are assured that every bottle of alcohol is properly labeled, taxed, and sold only to responsible adults.

In order to understand how the three-tiered system operates as a partner with the state and federal regulatory communities and serves the interests of consumer protection, I would ask you to follow a bottle as it flows through the three-tiered system.

A supplier must obtain approval for the label from the BATF to ensure that it contains truthful and non-misleading information and that it contains mandatory health warnings. That bottle must then be sold to a state and federally licensed wholesaler who is responsible for maintaining and filing detailed records of each bottle brought into the state, pays the excise taxes due on the alcohol, and delivers the alcohol to a state licensed retail establishment. The retailer is responsible for paying over to the state the sales taxes generated by each sale, and is directly responsible for ensuring that alcohol does not fall into the hands of minors or other prohibited individuals. Since both the wholesaler and the retailer must be licensed by the state, they are fully accountable for any dereliction of their duties. They are subject to on-site inspections, auditing and compliance checks, and any violation can result in a loss of license, fines and other potentially more severe penalties.

It is this responsible, consumer oriented state-run system that proponents of direct shipping of alcohol beverages seek to dismantle. To truly understand the dangerous unregulated alcohol distribution system that they suggest take the place of the three-tiered system, it is helpful to illustrate how direct to consumer sale would differ from the current model.

First, there is no guarantee that sales would not be made to minors. Since states are unable to effectively monitor direct sales to consumers, there is no guarantee that the person ordering the alcohol is of age. Online systems, since they are not face-to-face, simply cannot ensure that sales are not made to minors. Most teenagers between the ages of 18 and 21 years of age (and many who are younger) possess credit cards allowing them to order online—others have the use of their parents' cards; there is no way for the online supplier to accurately verify the age of the person ordering.

Moreover, there is no way to ensure that a minor does not ultimately receive a shipment of alcohol. The suppliers wash their hands of the alcohol once it leaves their premises, and there is no guarantee that the delivery service will require an I.D. upon delivery—or that they will not simply drop the box off at the door unattended.

That is exactly what happened when scores of media outlets conducted stings over the past several years to determine the safety of direct sales. Those stings showed how easy it was for minors to order alcohol online—and how sloppy the carriers were who delivered the alcohol, often without checking I.D. and often just leaving the alcohol on the front doorstep. Perhaps more telling, a recent sting by the Michigan AG's office ensnared 79 different companies who illegally shipped 1,020 bottles of wine, 318 bottles of beer and 20 bottles of spirits, many of those sales going to underage buyers.

Proponents of direct shipping alcohol beverages discount the implications of those stings, claiming they are somehow tainted and the product of wholesaler orchestration. While we would like to claim credit for these illuminating stings, wholesalers do not control the media nationwide and certainly do not control the Michigan Attorney General's office. But that really isn't the point; the fact is that the companies caught up in these stings either did not have adequate controls to avoid selling to minors, or that they simply didn't care if they did sell to minors.

Direct shipping advocates also misconstrue the meaning of statistics from the states, attempting to compare the number of prosecutions for illegal face-to-face sales to minors when compared with the smaller number of direct to consumer

transactions being prosecuted. However, the simple fact is that state budgetary constraints make costly Internet sting operations less favored than local compliance checks. In addition, it is the very nature of the three-tiered system that provides for the apprehension of those retailers who would sell to minors, a safeguard that is impossible to implement with respect to online sales—unless one relies on precisely the type of enforcement actions that the pro-direct shipping advocates denigrate.

Second, when a bottle of alcohol is shipped direct to a consumer from a reciprocal state, the tax revenue that would normally have been collected by the receiving state wholesaler and retailer is lost. States depend on these taxes for a variety of vital programs, not the least of which is the funding of the regulatory agency itself. The states are already suffering from a dearth of tax income due to the recent recession and dive in stock market generated tax revenue. Should the reciprocal system that direct shipping advocates support actually go into effect, the states will take an even greater hit on their tax base.

Some argue that a state could set up instead a licensed direct shipment statute similar to that which Louisiana has created. However, any such system ultimately relies upon “the kindness of strangers.” There is no way to conduct on-premises inspection of the books of these “licensees” to determine the accuracy of their reports as there is with in-state entities—and there is no easy way to shut them down if violations occur. These companies often claim when caught that they are not subject to the jurisdiction of the receiving state, and the cost of court action to hold out-of-state interests accountable for any violation of their “license” would be prohibitive. It is simply much easier and much more cost efficient for the state to focus their compliance efforts on in-state interests than on out-of-state concerns.

Third, the alleged cost savings from direct shipment are non-existent—and in fact the price is often cheaper for the same bottle purchased locally. Why? Because the online suppliers do not list wine online at the wholesale price, they list it at the retail price. Thus, while the supplier captures the additional profits that would have accrued to the wholesaler, the retailer and the state, the consumer sees no differential in the price. Unless, of course, you add in the additional costs of shipping, in which case the consumer actually ends up paying more for the bottle than had the purchase gone through the three-tiered system in the first place.

The proponents of direct shipping argue that wholesalers stifle competition and that wholesaler consolidation has contributed to the inability of some small wineries from accessing existing distribution channels. This argument does not pass the laugh test. You could have 10,000 wholesalers in every state, but that would not correspondingly increase the amount of shelf space available in retail stores, which are glutted with hundreds of brands of wines.

Further, there is nothing about the three-tiered system that could be considered unfairly restrictive of trade in the marketplace. No wholesaler’s phone number is unlisted. No legitimate supplier is refused the opportunity to display and market his or her products at the wholesaler’s annual convention. In fact, there are hundreds of imported wines that have managed to compete quite successfully in the American marketplace despite the wholesalers alleged monopolistic hold on the three-tiered system—a subject deliberately overlooked in proponent’s arguments.

Finally, no wine and spirit wholesaler would fail to market any quality wine for which there is a demand—they are consummate businessmen who have succeeded by understanding the rules of the market; you make profit by marketing and selling beverages that are in demand—period.

Vintner trade groups highlight with pride the increase in U.S. wineries from 800 in 1975, to 1400 in 1995, to 2,700 today. However, at the same time, these groups fail to recognize that wine must answer to the same economic imperatives as other products, and that perhaps that growth was simply not sustainable and was based upon an “irrational exuberance” unrelated to the realities of the marketplace. Having thus failed to accurately assess the marketplace, those wineries now want to be rescued, overnight, by fundamentally altering a regulatory system that has successfully evolved to the benefit of our nation’s consumers over the past 69 years. I would submit to the Subcommittee that it is not the federal government’s job to bail out every group of entrepreneurs that ignores the realities of the marketplace and suffers the consequences.

In addition, the Subcommittee should be aware that there have been several court decisions, including district court decisions in Florida, Michigan, and the 7th Circuit decision in the *Bridenbaugh* case, the highest court to have addressed the issue of direct shipping, which have upheld state rights under the 21st Amendment. Conversely, only a few have found to the contrary.

However, if you read the decisions—instead of simply reading the won/loss columns—you would discover that the better reasoned decisions are the ones which up-

hold state laws and show deference to state concerns relating to temperance, maintaining an orderly marketplace, and ensuring tax revenue. They make sense both historically and legally. Prior to prohibition, states had a great deal of difficulty regulating traffic in alcohol originating in other states. Although the courts had no problem with a state licensing and regulating suppliers within their borders, those same courts consistently ruled that the dormant commerce clause prevented them from regulating imports from unlicensed out-of-state suppliers as an unlawful interference with interstate commerce.

In response to those cases, Congress passed the Webb-Kenyon Act—entitled “An Act Divesting Intoxicating Liquors of Their Interstate Character in Certain Cases”—that was designed to cede federal commerce clause power to the states in an effort to provide them with the authority to effectively regulate the importation of alcohol. However, it wasn’t until the end of prohibition that Congress passed, and the states ratified, the 21st Amendment, formalizing within our constitutional framework the delegation of commerce clause authority to the states in the area of alcohol importation and shipment.

Once you understand that history, it becomes abundantly clear that the Webb-Kenyon Act and the 21st Amendment were designed to reverse discrimination that favored out-of-state suppliers, as Judge Easterbrook noted in his seminal opinion in the *Bridenbaugh* case. Prior to those enactments, it was in-state concerns that bore the burden of discriminatory regulation. Only they had to be licensed; only they had to pay taxes; and only they were accountable to the state. It was only upon passage of the 21st Amendment that the states were free to require that all suppliers, in state and out-of-state, be subject to their alcohol distribution regulatory frameworks.

The proponents of direct shipping have applauded the decisions of courts in North Carolina, Virginia and Texas that have struck down as “discriminatory” certain state laws prohibiting interstate direct shipping. But what would those cases accomplish if upheld on appeal? They would nullify the 21st Amendment and bring us back to the days when only in-state suppliers were required to be licensed, regulated and taxed. While the proponents of direct shipping may disagree with prohibitions on interstate direct shipments, it is duplicitous of them to fight against what they perceive as discriminatory barriers—while at the same time encouraging the courts to craft a remedy whose effect would be to effectively discriminate against in-state suppliers. And that is just what the courts rulings in North Carolina, Virginia and Texas would lead to “unlicensed, untaxed and unaccountable out-of-state suppliers competing on an uneven playing field with licensed, taxed and accountable in-state suppliers.

You should also take note that Section 2 of the 21st Amendment unambiguously proclaims that:

The transportation or importation into any state, territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.

It does not make any distinction between wine, spirits and beer. Constitutionally, alcohol is alcohol. However, it is clear that the proponents of direct shipping want you to believe that wine is somehow different—that wine is just another agricultural product—not a socially sensitive product subject to potential abuse.

Low production winemakers and other proponents of direct shipping like to point out the *H.P. Hood* case, in which the Supreme Court asserted “every farmer and craftsman shall be encouraged to produce by the certainty that he will have free access to every market in the Nation.” What they overlook in their enthusiasm is that the justices in the *H.P. Hood* case were not speaking about alcohol beverages! I am sure that vintners consider themselves simply farmers, but that doesn’t mean the Supreme Court would ignore the high alcohol content of their product to place it in the same realm of consideration as wheat.

I would remind the Subcommittee that in safe guarding the best interests of consumers, it is the legislature of each state that most directly speaks to the concerns and choices of its citizenry. This premise is clearly supported by the 21st Amendment when it comes to the distribution of alcohol beverages. In fact, some legislatures have found their citizenry to support such control in the distribution of alcohol beverages that they have authorized only the state government to act in the role of a wholesaler or retailer. Other states favor controlling the distribution of alcohol through the licensing of private companies. Still others have even legislated dry areas or prohibitions against Sunday sales. Despite these widely varied systems of distribution in the states, they all have one thing in common. They were created in legislatures, by virtue of the power granted to the states under the 21st Amendment.

Unless the 21st Amendment is repealed, this Subcommittee should consider that unambiguous delegation of state authority and recognize that alcohol beverages are

a product with a unique standing in the American culture and economy. As such, it is the firmly held opinion of the Wine and Spirits Wholesalers of America that the distribution of alcohol beverages does not belong in a forum debating federal intervention in other forms of non-constitutionally empowered state regulation. Thank you.

Sincerely,

JUANITA D. DUGGAN, *CEO and EVP*